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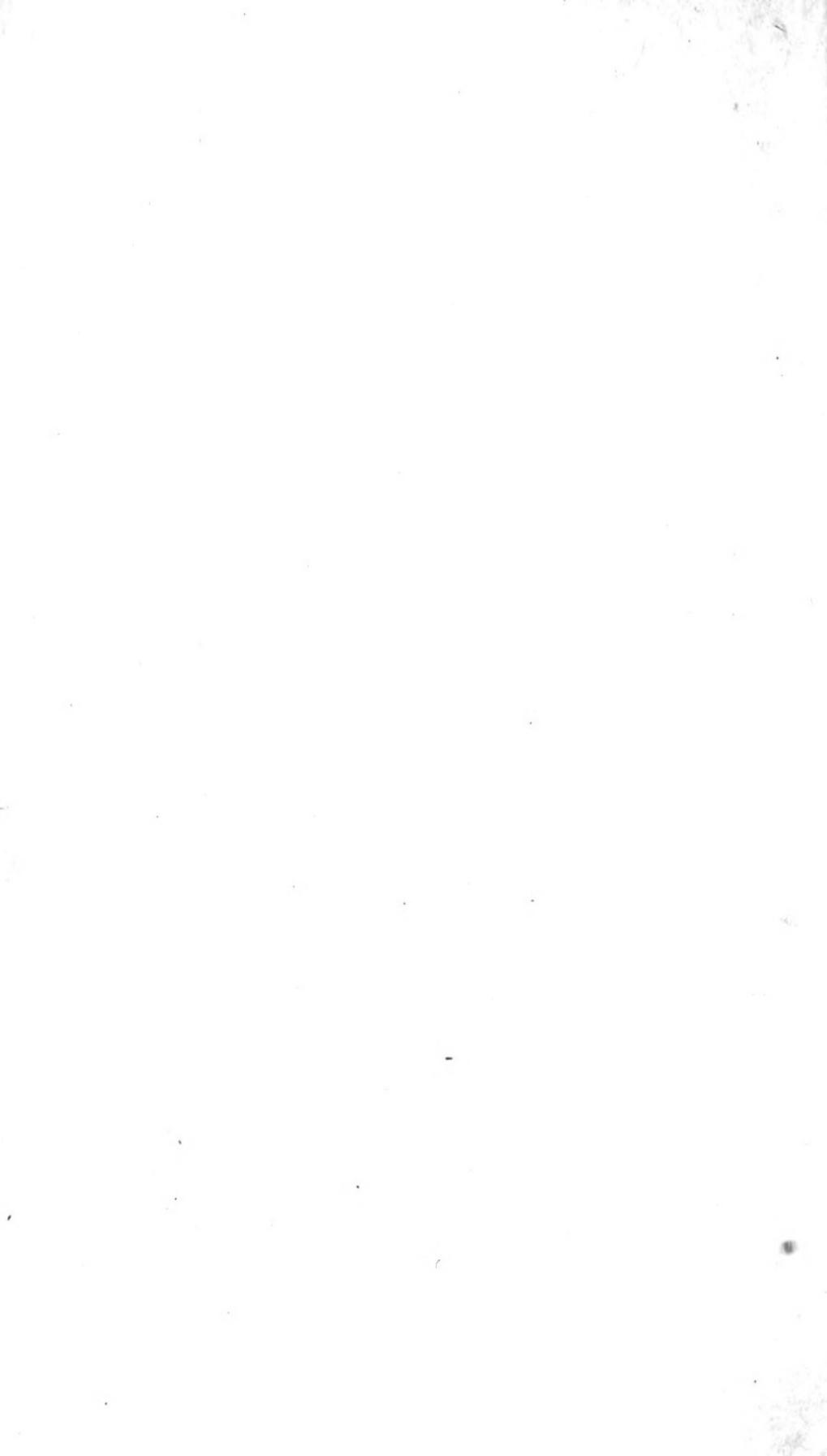
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No. 10806

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United States  
Circuit Court of Appeals  
For the Ninth Circuit.

— 2392

BARNHART-MORROW CONSOLIDATED, a  
corporation,  
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent.

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Transcript of the Record

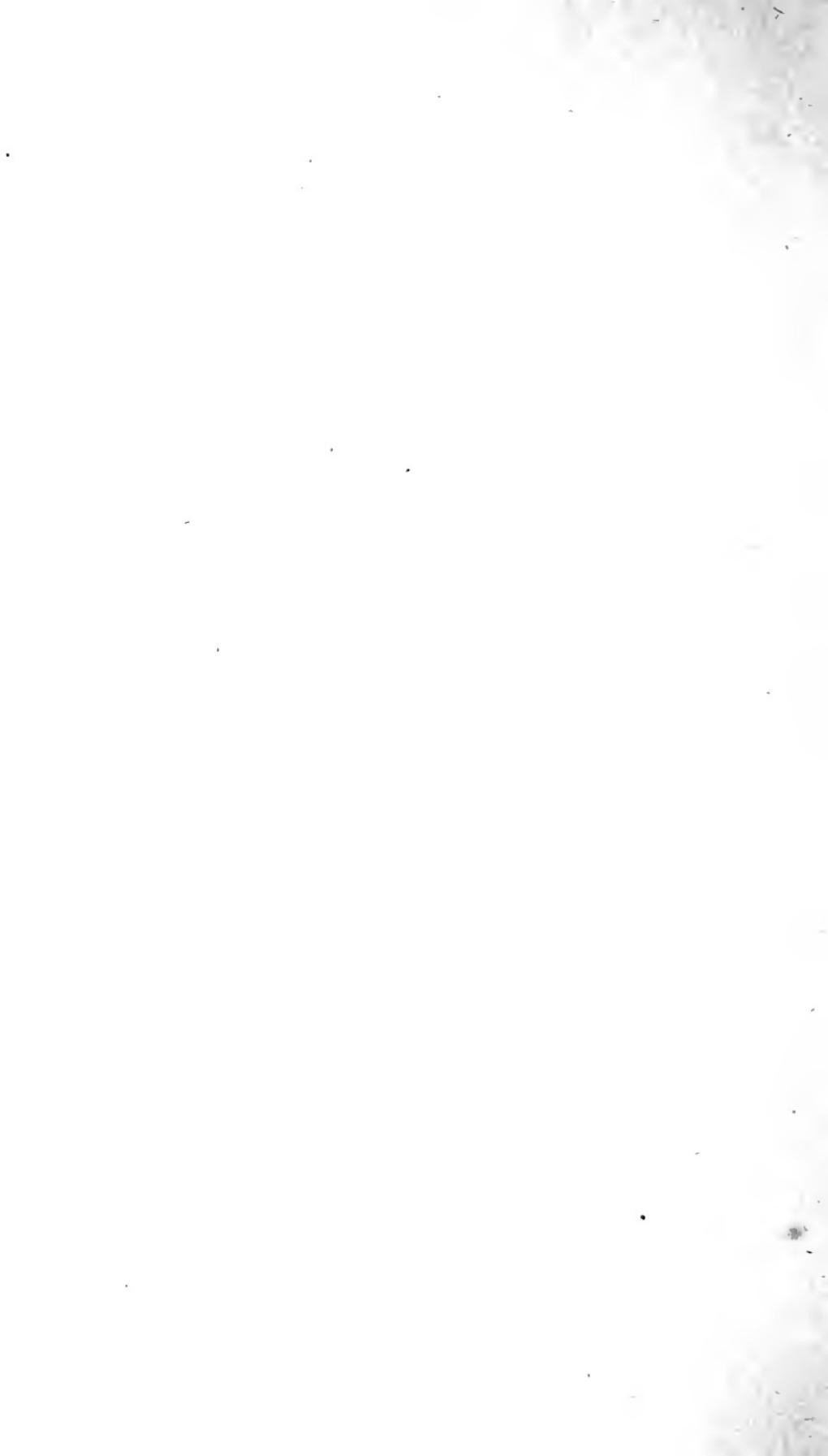
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Upon Petition to Review a Decision of the Tax Court  
of the United States

FILED

AUG 31 1944

PAUL P. O'BRIEN,  
CLERK



**No. 10806**

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United States  
Circuit Court of Appeals  
for the Ninth Circuit.

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BARNHART-MORROW CONSOLIDATED, a  
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Transcript of the Record

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Upon Petition to Review a Decision of the Tax Court  
of the United States



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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in italic; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in italic the two words between which the omission seems to occur.]

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## APPEARANCES:

For Taxpayer:

GEO. F. MEITNER, C. P. A.  
HAROLD C. MORTON, ESQ.,  
B. W. BURKHEAD, ESQ., A. S. F.

For Commissioner:

E. A. TONJES, ESQ.,  
R. C. WHITLEY, ESQ.

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Docket No. 185859

BARNHART-MORROW CONSOLIDATED,  
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent.

## DOCKET ENTRIES

1940

Dec. 13—Petition received and filed. Taxpayer notified. Fee paid.

Dec. 13—Copy of petition served on General Counsel.

Dec. 13—Request for Circuit hearing in Los Angeles, Calif. filed by taxpayer. 12-13-40  
Copy served.

1941

Jan. 29—Answer filed by General Counsel.

Jan. 31—Notice issued placing proceeding on Los Angeles, Calif. calendar. Service of answer and request made.

1941

July 15—Hearing set Sept. 22, 1941 in Los Angeles, California.

Oct. 4—Hearing had before Mr. Disney on the merits. Submitted. (Stipulation as to facts filed.) Appearance of B. W. Burkhead filed. Briefs due from petitioner 11-25-41. Respondent 12-24-41. Reply briefs 1-10-42.

Oct. 21—Transcript of hearing 10-4-41 filed.

Nov. 24—Brief filed by taxpayer. 11-24-41 Copy served on General Counsel.

Dec. 24—Motion for extension to Jan. 24, 1942 to file reply brief filed by General Counsel. 12-26-41 Granted.

1942

Jan. 9—Motion for extension to Feb. 16, 1942 to file reply brief filed by taxpayer. 1-9-42 Granted.

Jan. 13—Reply brief filed by General Counsel. Served 1-13-42.

Feb. 16—Reply brief filed by taxpayer. 2-16-42 Copy served on General Counsel.

Aug. 20—Findings of fact and opinion rendered, Disney, Judge, Div. 4. Decision will be entered under Rule 50. 8-26-42 Copy served.

Sept. 17—Motion for reconsideration of decision or rehearing and for additional findings filed by taxpayer.

**1942**

Dec. 4—Order that to the extent that the motion relates to a rehearing and to reconsider the issues on loss deduction for well No. 16 and insolvency be denied, and (a) certain figures be inserted in lieu of figures appearing on pages 7, 8, 14 and 17 of the printed opinion and (b) the findings of fact be amended and further order that allowances for depletion in the taxable years be recomputed under Rule 50 in accordance with the findings of fact of this Court, as amended and supplemented by this order entered. [1\*]

**1943**

Feb. 10—Computation of deficiency filed by General Counsel.

Feb. 10—Motion for leave to file attached amendment to answer asking for increased deficiency, amendment to answer asking for increased deficiency lodged, filed by General Counsel. 3-9-43 Granted.

Mar. 9—Hearing set March 31, 1943 on settlement.

Mar. 26—Computation of deficiency filed by taxpayer.

Mar. 26—Motion for continuance to 5-3-43 filed by taxpayer. 3-29-43 Granted to 5-5-43.

Mar. 29—Copy of computation served on General Counsel.

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\*Page numbering appearing at top of page of original certified Transcript of Record.

1943

May 5—Hearing had before Judge Disney on settlement under Rule 50. Held C. A. V. Respondent's memorandum filed. (Copy served on petitioner at hearing). Briefs due, none.

May 8—Transcript of hearing 5-5-43 filed.

July 30—Order that paragraph (b) of order of 12-4-42 be modified and further ordered that parties submit recomputations under Rule 50 in accordance with the findings of fact as amended and supplemented by this order entered.

Nov. 18—Revised computation of deficiency filed by General Counsel.

Nov. 24—Hearing set Dec. 22, 1943 on settlement.

Dec. 20—Motion for continuance to Jan. 3, 1944 filed by taxpayer. 12-21-43 Granted to 1-5-44.

1944

Jan. 1—Recomputation filed by taxpayer. 1-3-44 Copy served.

Jan. 5—Hearing had before Judge Disney on settlement. Uncontested.

Jan. 7—Memorandum in support of Rule 50 recomputation filed by taxpayer.

Jan. 24—Decision entered, Disney, Judge, Div. 4.

Feb. 17—Motion for rehearing and vacating decision Jan. 24, 1944 filed by taxpayer.

Feb. 29—Order that petitioner's motion of 2-17-44 is denied entered.

1944

May 15—Petition for review by U. S. Circuit Court of Appeals, 9th Circuit, with assignments of error filed by taxpayer.

May 16—Proof of service filed by taxpayer.

May 16—Designation of portions of record filed by taxpayer with proof of service thereon.

May 16—Statement of points filed by taxpayer.

[2]

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United States Board of Tax Appeals

Docket No. 105859

BARNHART-MORROW CONSOLIDATED,  
Petitioner,  
vs.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent.

PETITION

The above named Petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his Notice of Deficiency (IT:LA:PB-90D) dated September 18, 1940, and as a basis of its proceedings alleges as follows:

1. The Petitioner is a corporation organized under the laws of the State of California under date of December 24, 1926 with its principal office at Suite 1020 Subway Terminal Building, 417 South Hill Street, Los Angeles, California. The returns

for the calendar years 1936 and 1937 here involved were filed with the Collector of Internal Revenue for the 6th District of California.

2. The Notice of Deficiency (a copy of which is attached and marked Exhibit "A") was mailed to the Petitioner on September 18th, 1940.

3. The taxes in controversy are income taxes for the calendar year 1936 consisting of normal tax approximating \$9,161.06 and surtax on undistributed profits of \$18,342.69 or a total of \$27,503.75 for the year 1936, and income taxes for the calendar year 1937 consisting of normal tax of \$6,321.00 and surtax on undistributed profits of \$9,495.89 or a total of \$15,816.89 for the year 1937. [3]

4. The determination of the income taxes set forth in the said Notice of Deficiency is based upon the following errors:

(a) The Respondent erred in determining what constitutes the gross income of the Petitioner, for the year 1936, from the sale of oil and gas produced, and as respects each of Petitioner's oil wells.

(b) The Respondent erred in determining what constitutes the net income of the Petitioner, for the year 1936, from the sale of oil and gas produced, and as respects each of Petitioner's oil wells.

(c) The Respondent, in erroneously determining what constitutes the gross income and what constitutes the net income of the Petitioner, for the year 1936, from the sale of oil and gas produced, and as respects each of Petitioner's oil wells; erred in determining the amount of depletion allowable for the

year 1936, and as respects each of Petitioner's oil wells.

(d) The Respondent erred in including as income for the year 1936, the sum of \$7,000.00 salary accrued in 1931, in dispute and cancelled on Petitioner's books in 1936.

(e) The Respondent erred in disallowing as a bad debt deduction for the year 1936, the sum of \$16,500.10.

(f) The Respondent erred in disallowing as a loss deduction for the year 1936, the worthlessness of the fractional interest of the Petitioner in a Patent.

(g) The Respondent erred in disallowing as a deduction from income for the year 1936, receivership expenses in the sum of \$11,908.53.

(h) The Respondent erred in failing to determine that the Petitioner was insolvent during the period of receivership in the year 1936 and accordingly erred in determining that the Petitioner was subject to a surtax on undistributed profits for the year 1936 under the provisions of Section 14 of the Revenue Act of 1936. [4]

(i) The Respondent erred in determining what constitutes the gross income of the Petitioner for the year 1937, from the sale of oil and gas produced, and as respects each of Petitioner's oil wells.

(j) The Respondent erred in determining what constitutes the net income of the Petitioner for the year 1937, from the sale of oil and gas produced, and as respects each of Petitioner's oil wells.

(k) The Respondent, in erroneously determining what constitutes the gross income and what constitutes the net income of the Petitioner, for the year 1937, from the sale of oil and gas produced, and as respects each of Petitioner's oil wells; erred in determining the amount of depletion allowable for the year 1937, and as respects each of Petitioner's oil wells.

(l) The Respondent erred in disallowing depletion in the amount of \$3,857.29 claimed by the Petitioner for the year 1937 on the income received by the Petitioner in the year 1937 on the Participating Oil Agreement Interests held in Julian Wells Nos. 1, 2 and 3.

(m) The Respondent erred in disallowing as a loss deduction the sum of \$43,151.96 sustained by the Petitioner in the year 1937, on the quitclaiming and relinquishment of Petitioner's interest in Julian Well No. 16.

(n) The Respondent erred in disallowing as a deduction from income for the year 1937, interest accrued in the amount of \$300.17 on the liability of Federal Income and State Franchise Taxes of the Petitioner payable on the net income for the year 1936.

(o) The Respondent erred in disallowing as a deduction from income for the year 1937, capital stock taxes accrued as of December 31, 1937 in the additional sum of \$441.00.

(p) The Respondent erred in disallowing as a business expense legal fees paid in the additional sum of \$250.00. [5]

5. The facts upon which the Petitioner relies as a basis of this proceeding are as follows:

(1) (a) Barnhart-Morrow Consolidated, a corporation, was organized under the laws of the State of California under date of December 24, 1926 for the purpose of acquiring all of the assets of Bar-Mor Petroleum Corporation, and Barnhart-Morrow and Company, Incorporated, both California corporations, and other producing and non producing oil properties.

(b) The said Barnhart-Morrow Consolidated keeps its books and records on the accrual basis and its income tax returns for the years 1936 and 1937 as well as for all years prior thereto have been filed on the accrual basis in reporting net taxable income.

(c) Among the assets acquired by said Barnhart-Morrow Consolidated from its immediate two predecessor companies was an "Operating Agreement" dated January 15, 1925, wherein C. C. Julian, acting for and in behalf of himself individually and as agent for the holders of Participating Oil Agreements and holders of Per Cent Interstate, executed and delivered to, with and in favor of W. J. Barnhart and D. R. Morrow, the said Operating Agreement. The assignment of said Operating Agreement, to said Barnhart-Morrow Consolidated was consented to by said C. C. Julian. Said Operating Agreement embraces and covers the mineral properties known as the Brunson Lease and upon which premises were drilled Julian Wells Nos. 1, 2, 3, 4, 5, 11 and 12. On August 24, 1929, for a valuable consideration, said C. C. Julian, acting for and in

behalf of himself individually and as agent for the holders of Participating Oil Agreements and holders of Per Cent Interests in said wells, made, executed and delivered to, with and in favor of Barnhart-Morrow Consolidated an amendment thereto, by the terms of which the said Barnhart-Morrow Consolidated became entitled to an additional 15% of the proceeds of the sale of oil from said oil wells, making a total of 65% of the proceeds of oil and 50% of the gross proceeds from gas [6] after deducting landowners' royalties, and oil and gas consumed in the operation of said wells.

(2) (a) On or about March 9, 1928 United Oil Well Supply Company, a corporation, of Los Angeles, California, Wm. B. Himrod, and W. W. Hyams, owners of fee title to the property hereinbelow described, together with Lem A. Brunson and Clara Brunson, his wife, as lessors, executed and entered into an oil and gas lease with W. J. Barnhart, as lessee, which lease was recorded August 6, 1928 in Book 7274, Page 1 of Official Records of Los Angeles, County, California. Said lease, for convenience, is hereinafter referred to as the United Lease, and covers the following described property:

The North Half of the North Half of the Northeast quarter of the Southwest quarter of Section Six, Township Three South, Range Eleven West, S. B. B. & M. in the County of Los Angeles, State of California.

Excepting therefrom such portions thereof as are specifically set out in said lease.

(b) Said United Lease is subject to all of the rights of C. C. Julian under and pursuant to a certain lease dated June 2, 1922 by and between Globe Petroleum Corporation, a corporation, as lessor, and C. C. Julian as Lessee, and likewise subject to all of the rights of C. C. Julian under and pursuant to a certain lease dated March 26, 1923 by and between Globe Petroleum Corporation, a corporation, as lessor, and C. C. Julian, as lessee, and of all renewals and ratifications thereof.

(c) That the terms of the said United Lease provide for the payment of 16-2/3% landowners' royalty of all oil, gas and other hydro-carbon substances produced and saved from any wells drilled to a depth in excess of 6000 feet, unless oil is found in commercial paying quantities below the Meyer sand, and at a depth not to exceed 6000 feet; and further that in the event the lessee drills a well on said premises to the Meyer sand or to a sand at a lesser depth [7] than the Meyer sand, then and in that event the landowners' royalty shall be 20% of all oil, gas and other hydro-carbon substances produced and saved from the wells and the lessees interest in the production from said wells shall then be 80%.

(3) (a) After the execution of said United Lease, and on or about September 28, 1928, said W. J. Barnhart, jointly with his wife, Elsie D. Barnhart, assigned said United Lease to C. C. Julian, insofar as the same related to the

Westerly 543 feet of the premises covered

thereby, excepting therefrom a portion of the said Westerly 543 feet described as follows: Commencing at the Northwest corner of said Westerly 543 feet, thence South 150 feet on a line parallel with the Westerly boundary of said property; thence West 200 feet parallel with the Northerly line of said property to a point; thence North 150 feet to the Northerly line of said property; thence East 200 feet to the place of beginning.

(b) Said assignment was recorded in Book 7437, Page 290 of Official Records of Los Angeles County, California. Following the execution of said assignment of said Westerly 543 feet of the United Lease to said Julian, said Julian commenced the drilling of Well No. 17, which well is located in the Southeast 100 feet of the West 543 feet of the premises described in said United Lease.

(c) After C. C. Julian had commenced the drilling of Well No. 17, the said C. C. Julian on October 24, 1928, joined therein by his wife, Mary Julian, made, executed and delivered a written assignment to A. L. Jameson, of the said United Lease insofar as it applied to that portion of the property upon which said Well No. 17 was being drilled, such portion being more particularly described as follows:

That portion of the West 543 feet of the North Half of the North Half of the Northeast Quarter of the Southwest Quarter of Section 6, in Township 3 South, Range 11 West, S. B. B. & M., in Los Angeles County, California, described as follows: [8]

Commencing at a point in the Southerly line thereof, 543 feet distant from the Southwest corner of said property; thence North 121 feet on a line parallel with the Westerly boundary line of said property to a point; thence West 250 feet and parallel with the Southerly line of said property to a point; thence South 121 feet on a line parallel with the Westerly boundary line of said property to a point on the Southerly boundary line of said property, thence East 250 feet along the Southerly boundary line of said property to the place of beginning, containing 69/100 acres, more or less.

(d) On the same date, to-wit: October 24, 1928, said C. C. Julian and A. L. Jameson entered into an Operating Agreement with respect to Well No. 17 and the premises upon which the same is located, and so assigned by said Julian to the said Jameson, wherein it was provided that said Jameson should carry on the drilling of Well No. 17, and after payment of the lessors royalty of 1/6 under the terms of the United Lease, the said Jameson should receive from 83-1/3% of the production of the said well the sum of \$100,000.00, and thereafter all proceeds of production should be divided equally between said Jameson and said Julian. Said Jameson, thereafter, to-wit: on October 31, 1928, duly assigned to the Santa Fe Springs Oil Company, a corporation, all rights, so acquired by him with respect to said Well No. 17.

(e) Said Santa Fe Springs Oil Company drilled

said Well No. 17 to a depth in excess of 7000 feet or thereabouts, but did not produce from that depth. Thereafter, and on or about July 9, 1930, the said Santa Fe Springs Oil Company entered into an agreement with W. J. Barnhart, whereby said Barnhart agreed to develop said Well No. 17 upon production in the Meyer sand, and in consideration thereof, after payment of the royalty of 1/6 under the terms of the United Lease, the remaining 83-1/3% of the proceeds of production should be distributed equally to the Santa Fe Springs Oil Company and said Barnhart until such proceeds aggregated \$78,000.00 and thereafter such proceeds should be distributed 3-2/3% to the Santa Fe Springs Oil Company, 38% to said Barnhart, and 41-2/3% to C. C. Julian, as provided in said operating agreement between [9] Julian and Jameson. Thereafter, and on July 30, 1930, said W. J. Barnhart duly assigned all rights so acquired by the Santa Fe Springs Oil Company with respect to Well No. 17 to Barnhart-Morrow Consolidated, and Barnhart-Morrow Consolidated ever since has been and now is the owner of all rights conferred upon said Barnhart by said agreement of July 9, 1930 between the Santa Fe Springs Oil Company and W. J. Barnhart. That thereafter said Barnhart-Morrow Consolidated worked upon said Well No. 17 and placed the same upon production in the said Meyer sand.

(f) On or about December 5, 1928, C. C. Julian assigned, transferred and set over to one Wm. M. Cady, 30% of the residue of the proceeds of sale or other disposal of the net production from said Well

No. 17. That said Cady on or about July 10, 1929 assigned 10% out of such 30% to A. L. Jameson.

(g) That on or about December 1, 1931 the said Cady assigned 20% of such 30% assigned to Cady by said Julian to J. A. Smith.

(4) (a) On or about September 28, 1928, said W. J. Barnhart, joined by his wife, Elsie D. Barnhart, assigned to Barnhart-Morrow Consolidated that portion of the United Lease excepted and reserved as set forth in paragraph (3) (a) above in assignment made to C. C. Julian, and under which assignment there was reserved to W. J. Barnhart a one-half interest in the well to be drilled on the premises so excepted and reserved.

(b) That on the same day, to-wit: On September 28, 1928, said W. J. Barnhart, and Barnhart-Morrow Consolidated entered into an Operating Agreement in respect to Well No. 16 and the premises upon which the same is located and so assigned by said Barnhart to the said Barnhart-Morrow Consolidated wherein it was provided that said Barnhart-Morrow Consolidated agrees to immediately drill a well thereon to productive deep sands underlying said property and below 5000 feet depth. The said Operating Agreement by its terms provided for the payment of 1/6 royalty of all oil, gas, and other hydro-carbon substances [10] produced and saved from the well to the owners of the property as provided in said United Lease, and that said Barnhart-Morrow Consolidated shall be entitled to take and receive for its own use and benefit out of the 83-1/3% of the oil, gas and other hydro-carbon substances

produced and saved from said Well, \$100,000.00 as its cost for drilling such well. That after said Barnhart-Morrow Consolidated shall have received the said sum of \$100,000.00 out of the first 83-1/3% of production, that thereafter the 83-1/3% of production shall be divided equally between the said Barnhart and Barnhart-Morrow Consolidated provided that the said Barnhart-Morrow Consolidated shall first be entitled to deduct from said 83-1/3% of the production from said well its necessary operating expenses which in no event shall exceed a sum which would amount to \$250.00 per month, when said well is flowing, nor more than \$500.00 per month when said well is pumping.

(c) On or about September 28, 1928, said W. J. Barnhart, joined by his wife, Elsie D. Barnhart, assigned to one Wm. M. Cady all of the right, title and interest of the said Barnhart so reserved in assignment made by the said Barnhart to Barnhart-Morrow Consolidated. The reservation of said one-half interest in Well No. 16 by W. J. Barnhart and the assignment thereof by him to said Cady were done for the use and benefit of C. C. Julian, said assignment from Barnhart to Cady being for a consideration paid by said Cady to said Julian.

(d) On or about September 28, 1928, said W. J. Barnhart and C. C. Julian entered into a purported Option Agreement with Barnhart-Morrow Consolidated, wherein it was provided that in the event said Barnhart-Morrow Consolidated shall elect not to drill said well to productive sands underlying said property below 5000 feet in depth, but to stop the

drilling [11] of said well in the Meyer sand and produce therefrom, that the said Barnhart-Morrow Consolidated shall pay the said Julian the sum of \$2,500.00 and further that the said sum of \$100,000.00 to be retained by the said Barnhart-Morrow Consolidated out of the first 83-1/3% of the production as its cost for the drilling of such well shall be reduced to the sum of \$80,000.00

(e) That after the assignment of the leasehold premises and the execution of the operating agreement on September 28, 1928, between W. J. Barnhart and Barnhart-Morrow Consolidated, the said Barnhart-Morrow Consolidated commenced the drilling of an oil well on said premises known as Well No. 16, and did drill the same to the Meyer sand. Said oil well was completed and came on production on or about February 29, 1929.

(f) On or about July 25, 1929, said Wm. M. Cady assigned all of his right, title and interest in and to Well No. 16 to one James B. Boyle, but that said assignment to Boyle by Cady was in the way of collateral security only.

(g) On or about May 15, 1930, said C. C. Julian advised said Barnhart-Morrow Consolidated that he had theretofore assigned to H. B. Flesher all of his right, title and interest in and to the proceeds from Well No. 16 due and payable to him under the terms of the Operating Agreement under which said Barnhart-Morrow Consolidated drilled and was operating said Well, and that any payments so made to said Flesher and his receipt therefor shall consti-

tute a full and complete release of any interest said C. C. Julian had in such proceeds.

(h) On July 18, 1930 said Barnhart-Morrow Consolidated advised said C. C. Julian that on August 20, 1929 it had received a notice from one James B. Boyle in which said Boyle advised said Barnhart-Morrow Consolidated that he had succeeded to all of the rights of C. C. Julian and Mr. Cady by [12] assignment of that agreement made between W. J. Barnhart and Elsie D. Barnhart and Barnhart-Morrow Consolidated, which was an Operating Agreement to provide for the operation of Well No. 16.

(i) On July 25, 1930 the said C. C. Julian, through his attorney in fact, H. B. Flesher, advised said Barnhart-Morrow Consolidated that the said James B. Boyle had no interest in and to that certain assignment given by C. C. Julian to Wm. M. Cady in and to Well No. 16 except insofar as concerned oil produced from a depth in excess of 5000 feet; and, further agreed therein, to protect and indemnify the said Barnhart-Morrow Consolidated against any and all action or actions that might be brought against said Barnhart-Morrow Consolidated by reason of their paying to said C. C. Julian or to his properly authorized agent such sums of money to which said C. C. Julian was entitled in accordance with existing agreements.

(j) That during the year 1930 there was paid to H. B. Flesher, in accordance with instructions given by said C. C. Julian in his authorization under date of May 15, 1930, the sum of \$16,500.10, which

was on account of a total of \$17,983.47 payable out of production from said Well No. 16 in 1930 in excess of \$80,000.00 well costs retained by said Barnhart-Morrow Consolidated out of the first 80% of production from said well.

(k) That at the final adjudication of the matter of Julian vs. Schwartz in October 1936, it was determined by the company that the \$16,500.10 paid by it to H. B. Flesher for the account of C. C. Julian had been paid in error since it was determined by the Court in that cause of action that Wm. Cady had succeeded to all of the rights, title and interest of C. C. Julian in that well and that J. A. Smith had acquired by purchase such interest from said Cady. That said Barnhart-Morrow Consolidated paid to J. A. Smith the sum of \$16,500.10 which it had theretofore paid to H. B. Flesher for the account of C. C. Julian and that the amount so paid to J. A. Smith was chargeable [13] to C. C. Julian in accordance with the indemnification letter which said Barnhart-Morrow Consolidated had received from said Julian on July 25, 1930. That the said C. C. Julian left the United States some time in the fore part of the year 1933 and that the said C. C. Julian died on or about March 25, 1934. That the company could not collect this sum from said C. C. Julian was definitely known at the time said amount was paid to J. A. Smith, and accordingly the amount of \$16,500.10 was charged off as a loss sustained by the company in the year 1936 when it was paid and in which year it was definitely determined who was entitled to receive such money.

(1) That on or about December 1, 1931 Wm. M. Cady sold, transferred, and assigned all of his rights in and to Well No. 16 to J. A. Smith and that said assignment was consented to by James B. Boyle.

(m) That on or about March 1, 1937 Barnhart-Morrow Consolidated experienced considerable difficulty in producing Well No. 16, said well being off production from March 7, 1937 to May 7, 1937, due to a collapse of the tubing in said well. Said well again went off production on May 20, 1937 to June 4, 1937 and again from June 6, 1937 to June 11, 1937.

(n) That the said Well No. 16 again went off production on or about December 16, 1937 and pursuant to a Resolution passed by the Board of Directors of said Barnhart-Morrow Consolidated on December 17, 1937, the interest of the said Barnhart-Morrow Consolidated in Well No. 16 was abandoned and quitclaimed to J. A. Smith, who had acquired by purchase and succeeded to all of the rights, title and interest of W. J. Barnhart, the original lessee under the United Lease and from whom said Barnhart-Morrow Consolidated had acquired its interest. That because of said abandonment and quitclaiming in Well No. 16, said Barnhart-Morrow Consolidated sustained a loss in the amount of \$43,151.96. [14]

(5) (a) That in addition to the operations by the Taxpayer of Julian Wells Nos. 1, 2, 3, 11, 16 and 17 located in the Santa Fe Springs Oil District in Los Angeles County, of the State of California, Taxpayer operated oil wells in Kern County, California known as K. C. L. Well No. 1, K. C. L. Well No. 2, K. C. L. Well No. 3, and K. C. L. Well No. 4.

(6) (a) On or about July 8, 1929 judgment was rendered for \$10,925.98 against C. C. Julian in an action of Garliepp and Mack vs. C. C. Julian, Superior Court Case No. 273-608. That thereafter and on or about December 9, 1929, the Sheriff of Los Angeles County, acting under a Writ of Execution issued in said action, pretended to sell to one R. L. Mack all of the right, title and interest of the said C. C. Julian, as an individual, in and to that property described in the Sheriff's Certificate of Sale on Execution, which involved the property on which Julian Wells Nos. 1, 2, 3, 11, 16 and 17 were drilled and other property in which taxpayer herein had no interest.

(b) That on or about December 11, 1930, a Sheriff's Deed to said property was executed and delivered by the Sheriff of Los Angeles County to said R. L. Mack who subsequently sold and assigned all of the right, title and interest so acquired under said Sheriff's Certificate of Sale on Execution and Sheriff's Deed to one W. A. Schwartz. That thereafter the said Schwartz served written notices on Barnhart-Morrow Consolidated, Walter J. Barnhart, Citizens National Trust and Savings Bank, et al; that he, said Schwartz, is entitled to the immediate possession of the real property upon which said oil wells above described have been drilled, and to the oil wells drilled thereon, and to the oil produced and to be produced therefrom, and asserted that he, the said Schwartz, intends to and will take over the possession of the said wells and the production therefrom

and intends to maintain and operate the said wells as his own property. [15]

(7) (a) That thereafter and on or about January 27, 1931, C. C. Julian, as plaintiff, filed an action against W. A. Schwartz, et al., in the Superior Court in the State of California, in and for the County of Los Angeles, Superior Court Case No. 315-345. The said C. C. Julian filed such action as a trustee of an express trust for the benefit of certain beneficiaries under the Declarations of Trust with the Citizens National Trust and Savings Bank of California. That the said action so filed was for the purpose of forever quieting the adverse claim of said W. A. Schwartz, defendant in said suit, in and to the mineral rights of the leasehold properties on which were drilled Julian Wells Nos. 1, 2, 3, 11, 12, 16, 17 and other wells in which taxpayer herein had no interest. That on or about March 16, 1931, said W. A. Schwartz, defendant in the matter of Julian vs. Schwartz, above mentioned, filed his answer in said cause of action, and that on or about the same day the said Schwartz filed his Cross-Complaint in said action, wherein the said Schwartz requested the appointment of a receiver; that an accounting be had of all sums received by Julian, Barnhart and Barnhart-Morrow Consolidated and that all interests of the parties be fixed and determined.

(b) That on or about March 19, 1931, Chas. F. Allison was appointed receiver and took possession of the properties and operated the same. That on or about March 25, 1932, the said Allison was re-

moved as receiver and C. L. Olson and J. A. Smith were subsequently appointed successors as co-trustees to take possession of the oil properties and operate the same during pendency of said cause of action. That all of the net proceeds from operation were impounded pursuant to the order of the Court by the said Allison and said Olson and Smith for the period March 19, 1931 to and including November 14, 1936, on which date the said oil properties [16] involving Julian Wells Nos. 1, 2, 3, 11, 16 and 17 were returned to the possession of Barnhart-Morrow Consolidated.

(c) That after the filing of said Cross-Complaint by said W. A. Schwartz the said C. C. Julian failed to answer the same and that Barnhart-Morrow Consolidated and other Cross-Defendants named in said amended cross-complaint of said Schwartz were obliged to file an answer to said cross complaint.

(d) That the Court in its Findings of Fact in the matter of Julian vs. Schwartz found that said Action and Judgment in said cause of action of Garliepp, et al., vs. Julian, case No. 273-608 involved and arose out of an account between the plaintiffs therein and said C. C. Julian, that said action and judgment had no relation and was not in any manner connected with any of the oil wells or the premises involved in said matter of said Julian vs. Schwartz, and further found that the said C. C. Julian had no interest in the premises described in said Brunson Lease and said United Lease at the time of the levy of the Execution in said case of Garliepp vs. Mack and at the time of the said Ex-

ecution Sale; and, that pursuant to judgment rendered in the matter of Julian vs. Schwartz the said Cross-Complainant, said W. A. Schwartz take nothing by his Cross-Complaint except such rights as he acquired by purchase since the commencement of said action, as declared and established in paragraph 14 of said judgment.

(e) That pursuant to said Judgment in said matter of Julian vs. Schwartz rendered under date of September 7, 1933, affirmed by the District Court of Appeal of the State of California, 1st Appellate District, Division 1, on August 28, 1936, and rehearing in the matter denied by the Supreme Court of the State of California on October 28, 1936, there was distributed to the taxpayer herein in the years 1936 and 1937 cash and other [17] assets.

(f) That the cash and other assets distributed to Barnhart-Morrow Consolidated by the co-trustees in the matter of Julian vs. Schwartz in the year 1936 was in accordance with Court Order dated July 23, 1934, which Court Order was ineffective during pendency of the appeal in said cause of action, but became effective on October 28, 1936 when the matter was finally determined and adjudicated.

(g) That pursuant to paragraph 24 of said judgment issued in the matter of Julian vs. Schwartz, the Court reserved jurisdiction to settle the account of the trustees pendente lite of Wells Nos. 1, 2, 3, 11, 16 and 17 and to order distribution of money now in the possession of said trustees and/or re-

ceiver in the matter, to the persons entitled thereto, as concluded in the conclusions of law therein.

(h) That after said Judgment in said cause of action of Julian vs. Schwartz became final, the said trustees ordered a final audit and report to be made of their accounts and records and that such audit was made by Geo. F. Meitner and Co., who rendered their audit report under date of February 9, 1937. That the original report of said audit made by said Geo. F. Meitner and Co. was filed with the Court subsequently thereafter. That the said auditors in said audit report called attention to the fact that the Commissioner of Internal Revenue was proposing to assess an income tax and penalties against said co-trustees for the calendar years 1931 to 1935 inclusive, in an amount aggregating \$102,264.92. That undoubtedly the Commissioner would propose an additional tax against the said co-trustees on the net income of the co-trustees for the period in the year 1936 during which said co-trustees operated said wells in said cause of action, and that it had been recommended in such audit report that a sum of not less than \$145,000.00 should be withheld from distribution to the respective proprietary interests to protect the said co-trustees against any liability [18] for the proposed assessments. That in February 1937 a further distribution of funds held by the co-trustees was ordered by the Court, and of the amount so ordered to be distributed, the taxpayer herein received the sum of \$63,000.00. That on August 13, 1937 a conference was held in Washington, D. C., by Geo. F. Meitner, Attorney in Fact for

the said co-trustees, with representatives of the Treasury Department relative to protest filed with the Treasury Department against the proposed assessments against said co-trustees, and at which hearing agreement was signed to the effect that no income tax liability for the years 1931 to 1936 would be assessed against the co-trustees, but that the recipients of the funds distributed by the co-trustees are liable for income taxes on the funds so distributed by the co-trustees are liable for income taxes on the funds so distributed for the year or years in which distribution is made to them. That pursuant to said agreement so filed with the Treasury Department said auditors, Geo. F. Meitner and Co., made their final audit and issued their report in connection therewith on September 22, 1937 and the original of said audit report was filed with the Court in said cause of Action of Julian vs. Schwartz.

(i) That on October 19, 1937 the Court made its order approving account of co-trustees and directing co-trustees to distribute funds and assign accounts.

(j) That at the commencement of said action of Julian vs. Schwartz, and the appointment of a receiver therein, instructions of the Court were given to the effect that proper records shall be kept with respect to the income and operating cost of each of the oil wells involved separately. That such records were kept and that the income and operating cost of each of the oil wells involved are sep-

arately shown in the audit reports filed with the Court in said cause of action, and that pursuant to paragraph 10 of said judgment, said Barnhart-Morrow Consolidated is the absolute owner of said Operating Agreement as amended and entitled to have paid to it out of the [19] proceeds of the sale of oil and gas from Wells Nos. 1, 2, 3, and 11, 65% of such proceeds exclusive of landowners royalties and provided further that the share of Barnhart-Morrow Consolidated shall bear and discharge all expenses of operating, maintaining, redrilling or otherwise endeavoring to keep said well or any of them on production.

(k) That paragraph 12 of said judgment decrees that Barnhart-Morrow Consolidated is entitled to 41-2/3% of the gross proceeds in Well No. 17 until the proceeds of 83-1/3% of the production of said well shall have produced since the commencement of this Action the additional sum of \$29,679.88, and thereafter 38% of the gross proceeds from said well.

(l) That paragraph 13 of said Judgment decrees that said Barnhart-Morrow Consolidated is the owner of an undivided one-half interest in Well No. 16 and to the possession thereof.

(m) That the gross proceeds of Julian Wells Nos. 1, 2, 3, 11, 16 and 17 as determined pursuant to the Judgment rendered by the Court in the matter of Julian vs. Schwartz and as detailed in the Audit Report dated February 9, 1937 made by Geo. F. Meitner & Company, which gross proceeds so determined due to Barnhart-Morrow Consolidated, are as follows:

Oil Wells	Oil and Gas Proceeds	Cash Discounts and Sale of Junk
Julian Well No. 1.....	\$112,034.39	\$ 343.09
Julian Well No. 2.....	123,852.50	343.08
Julian Well No. 3.....	102,478.08	343.09
Julian Well No. 11.....	16,308.89	358.06
Julian Well No. 16.....	63,529.28	343.08
Julian Well No. 17.....	68,627.01	343.10
 Total.....	 \$486,830.15	 \$2,073.50

(8) (a) That on or about July 29, 1931 in an action brought in the Superior Court in and for the County of Los Angeles, known as Case No. 325061 by D. R. Morrow, as plaintiff, vs. Barnhart-Morrow Consolidated, a [20] corporation, and Guy L. Hardison and W. J. Barnhart under date of July 21, 1931, Ralph S. Armour was appointed receiver for the said Barnhart-Morrow Consolidated. That the said cause of action was filed in the Superior Court by the said D. R. Morrow for an accounting of the affairs of the corporation; for an accounting to the corporation by W. J. Barnhart, General Manager and Guy L. Hardison, President of the corporation, for any and all profits, including secret profits; and for unlawful payments as set forth in the Complaint; for contesting unlawful and excessive salaries paid to said Barnhart and Hardison; for their removal as officers of the corporation; and among other things set forth in the Complaint, for the appointment of a receiver to take charge of the affairs and assets of the corporation, pendente lite.

(b) That the said Ralph S. Armour, receiver for the corporation in said cause of action, was never

in complete charge nor had complete control of all of the assets of the corporation, since the oil properties, which said Barnhart-Morrow Consolidated had been operating prior to the appointment of receivers in the matter of C. C. Julian vs. Schwartz, were then in control and being operated by such receivers under orders of the Court issued in said cause of action. That at the time of the appointment of said Ralph S. Armour, as receiver, the said Barnhart-Morrow Consolidated was in an insolvent condition and continued to remain in such insolvent condition until the final adjudication of the matter of Julian vs. Schwartz and until such time that funds were released to it and to its Receiver to liquidate the receivership expenses of said Ralph S. Armour.

(c) That the said Barnhart-Morrow Consolidated was insolvent for the years 1931 to 1935 inclusive and until the final adjudication of the matter of Julian vs. Schwartz on October 28, 1936. [21]

(d) That pursuant to income tax returns and/or amendments thereto filed with the Treasury Department in Washington, D. C., and in connection with proposed additional assessments against the taxpayer for the years 1930, 1933 and 1934, and hearing had in Washington on August 13, 1937 relative to the proposed assessment for the said years above mentioned, the net income or losses of the taxpayer herein for each of the respective years were determined as shown below:

Year	Net Income or (Loss)*
1930 Net Income .....	\$ 3,175.54
1931 Net Loss .....	(90,116.67)*
1932 Net Loss .....	( 5,213.85)*
1933 Net Income .....	666.27
1934 Net Loss .....	( 2,516.00)*
1935 Net Loss .....	( 6,063.64)*

(e) None of the income impounded by the co-trustees in the matter of Julian vs. Schwartz was considered as income to the taxpayer herein until released to it. That in 1933 there was released for the account of taxpayer to J. A. Smith and in years subsequent thereto, pursuant to stipulation filed with the court in the year 1933, gas revenues produced by Julian Wells Nos. 1, 2, 3 and 11, accruing to Barnhart-Morrow Consolidated and which gas revenues pursuant to hearing held in Washington, D. C., on August 13, 1937, were determined to be income to Barnhart-Morrow Consolidated as having been constructively received by it in the year 1933 and in the years subsequent thereto. There was deducted from the income so considered as having been constructively received by the taxpayer, depreciation on the tangible equipment of the oil wells and other tangible lease equipment, which wells and other lease equipment were then being operated and/or used by the co-trustees in the matter of Julian vs. Schwartz. In addition to the depreciation so deducted there was also deducted and allowed business expenses paid and accrued, including legal fees and receivership expenses of Ralph S. Armour, receiver for the corporation. The receivership expenses so allowed, [22] were allowed as

deductions in and for the years in which they were definitely determined and approved by the Court in said cause of action No. 325061 wherein the said Ralph S. Armour was receiver.

(f) On November 12, 1936 Ralph S. Armour, receiver for said Barnhart-Morrow Consolidated filed his petition for approval to pay receiver's expenses with the Court in said cause of action No. 325061.

(g) That pursuant to hearing had the Court issued its order approving account and report of Ralph S. Armour, receiver, and directed termination of said receivership, that pursuant to said Petition and order of court issued in connection therewith, there was allowed and paid receiver's fees in the sum of \$6,143.32, auditing fees in the sum of \$1,875.00, legal fees in connection with the litigation of the case of Julian vs. Schwartz in the sum of \$7,400.00, appraiser's fees in connection with the sale of equipment salvaged from Hartley Well No. 1 in the sum of \$300.00 and insurance in the amount of \$333.53.

(9) (a) In December 1936 and in April 1937 Barnhart-Morrow Consolidated acquired by purchase "Regular and Special" Participating Oil Agreement interests in Julian Wells Nos. 1, 2 and 3.

(b) The Internal Revenue Agent in Charge is proposing to assess against Julian Wells Nos. 1, 2 and 3 Syndicates income taxes on the basis that the Syndicates are doing business in a corporate capacity, and are associations taxable as corporations. The "Regular and Special" Participating Oil Agreements acquired by Barnhart-Morrow Consolidated

are separate and distinct interests and/or estates in the residue from the proceeds from oil and the income received on the interests so held are depletable interests. Barnhart-Morrow Consolidated has been operating Julian Wells Nos. 1, 2 and 3 pursuant to its Operating Agreement as mentioned in paragraph (1) (c) hereof since [23] January 15, 1925, except for that period of time such wells were operated by the receiver and/or co-trustees in the matter of Julian vs. Schwartz and that at no time did the respective syndicates or the agent or agents thereof or the trustee operate said wells.

(c) Petitions have been filed with the United States Board of Tax Appeals by the Agents for Julian Wells Nos. 1, 2 and 3 Syndicates with respect to the proposed additional assessment for income taxes against such Syndicates by the Commissioner of Internal Revenue, which petitions are now pending hearing before and bear United States Board of Appeals Docket Numbers as follows:

	Docket No.
Julian Well No. 1 Syndicate .....	104172
Julian Well No. 2 Syndicate .....	104173
Julian Well No. 3 Syndicate .....	104174

and the facts as set forth in paragraph 5 of each of said petitions respectively is by reference made a part hereof as though fully set forth herein.

(d) In 1937 Barnhart-Morrow Consolidated received on the Participating Oil Agreement interests held by it in the respective oil wells, the following amounts:

Julian Well No. 1 ..... \$ 1,000.00  
Julian Well No. 2 ..... 1,000.00  
Julian Well No. 3 ..... 1,000.00

Julian Well No. 1 Syndicate .....	\$ 5,450.00
Julian Well No. 2 Syndicate .....	5,235.85
Julian Well No. 3 Syndicate .....	3,340.65
Total.....	\$ 14,026.50

(10) (a) Barnhart-Morrow Consolidated did file capital stock tax returns for the fiscal years ending June 30, 1933, and June 30, 1934, and in each of said returns claimed exemption from any liability for capital stock taxes for the years ending on said dates on the basis that the said company was inactive, not doing business and in the hands of a receiver. The exemption claimed by said Barnhart-Morrow Consolidated in capital stock tax returns filed by it for the years 1933 and 1934 was sustained by the Commissioner of Internal Revenue [24] in accordance with letter received from said Commissioner of Internal Revenue under date of January 30, 1936, copy of which letter is attached hereto, marked Exhibit "B", and by reference made a part hereof as though fully set forth herein. The said letter did further exempt the said Barnhart-Morrow Consolidated from the filing of any capital stock tax returns for subsequent years and so long as its business was under the control and management of a court, state or federal liquidating official.

(b) Ralph S. Armour was appointed receiver for Barnhart-Morrow Consolidated on July 29, 1931, was not discharged as such receiver until November 27, 1936 and accordingly said Barnhart-Morrow Consolidated was not liable for the filing of any capital stock tax returns until and for the fiscal

year ending June 30, 1937. Said Barnhart-Morrow Consolidated filed its capital stock tax return for the fiscal year ending June 30, 1937 and pursuant to its original declaration of value in such return paid a capital stock tax in the amount of \$800.00. Said return was filed pursuant to the provisions of Section 105 of the Revenue Act of 1935, as amended by Section 401 of the Revenue Act of 1936. Liability for payment of capital stock tax for the fiscal year ending June 30, 1937 accrued as of the first day of business done by Barnhart-Morrow Consolidated in 1936 and after the dismissal of its receiver, said Ralph S. Armour.

(c) There was accrued as of December 31, 1937, pursuant to the provisions of the Revenue Act of 1935 as amended by the Revenue Act of 1936, then in effect, capital stock tax for the fiscal year ending June 30, 1938 in the amount of \$791.00.

(d) Pursuant to the provisions of Section 601 of the Revenue Act of 1938, which act became effective on May 28, 1938, and which act [25] granted to the taxpayer the right to re-declare its value for capital stock purposes, the said Barnhart-Morrow Consolidated filed its capital stock tax return for the fiscal year ending June 30, 1938 with a declared value of \$350,000.00, and paid a tax thereon of \$350.00.

(11) (a) The net income of Barnhart-Morrow Consolidated for the year 1936 is \$42,828.07.

(12) (a) The net income of Barnhart-Morrow Consolidated for the year 1937 was a loss of \$2,864.70.

(13) (a) At the time Ralph S. Armour was appointed receiver for Barnhart-Morrow Consolidated there had been accrued on said corporation's books and records as "accrued pay roll" payable to Guy L. Hardison the sum of \$14,000.00. The said amount was accrued at the rate of \$1,000.00 per month to July 31, 1931.

(b) There was also recorded on the Company's records and shown as due to Mr. Hardison on July 31, 1931, the sum of \$8,500.00 representing two notes payable, dated July 30, 1930, due one year after date; one note being issued for \$4,000.00 and a second note for \$4,500.00. That said amount of \$8,500.00 so set up as a liability to Mr. Hardison on the Company's records arose out of a purported transaction relative to Mr. Hardison selling to the Company a certain oil well derrick and equipment pertaining to Well No. 17. The issuance of said notes to the said Hardison was approved by a resolution passed by the Board of Directors on July 30, 1930.

(c) In September 1931 Geo. F. Meitner and Co. were appointed auditors for Ralph S. Armour receiver for Barnhart-Morrow Consolidated, who made an audit of the said Barnhart-Morrow Consolidated's books and records for the period September 1, 1928 to and including July 31, 1931 and submitted [26] their report in connection therewith under date of February 10, 1932. That said auditors questioned various transactions, which were also at issue in the suit filed by D. R. Morrow wherein said Ralph S. Armour was appointed receiver, and that

among such items questioned were the salaries accrued to W. J. Barnhart and Guy L. Hardison and the notes of \$8,500.00 issued to said Guy L. Hardison. That the salaries and other items questioned in said report pertaining to W. J. Barnhart were settled by the company and Mr. Barnhart in 1932, and Mr. Barnhart waived all of the salary accrued to his credit, except \$7,000.00 thereof, and assigned to the company an escrow account in the amount of \$25,000.00 pertaining to other claims the Company had against said Barnhart. On July 31, 1931 there had been accrued on said corporation's books and records as "accrued pay roll", payable to W. J. Barnhart, the sum of \$27,752.64, of which amount \$20,752.64 was cancelled in 1932. The major portion of the amount accrued as salary to Mr. Barnhart originated in 1930 and the Treasury Department in accordance with examination made by it for the year 1930 disallowed as excessive salary accrued in that year and because such salary was waived in 1932 the sum of \$20,752.64.

(d) The salary accrued to Guy L. Hardison in the amount of \$14,000.00 and the \$8,500.00 notes as set forth above, both of which items were in dispute, was not settled until December 11, 1936, on which date the Board of Directors authorized the payment of \$7,000.00 for salary to Mr. Hardison, which amount paid his salary accrued on the company's records to December 30, 1930. The balance of the salary which was accrued on the company's records from January 1, 1931 to July 31, 1931 at \$1,000.00 per month and during which time a Receiver was

appointed in the matter of Julian vs. Schwartz and the oil properties operated by such Receiver, the salary accrued [27] to Mr. Hardison was not recognized or paid.

(e) In the same resolution the Board of Directors of Barnhart-Morrow Consolidated refused to recognize or pay any amount to the said Hardison for the notes issued to him aggregating \$8500.00 in connection with the purported transaction involving Well No. 17.

(f) Shortly after the appointment of Ralph S. Armour as Receiver for said Barnhart-Morrow Consolidated, funds were not available with which to employ help and accordingly said Barnhart-Morrow Consolidated or its Receiver did not keep up its books or records of account.

(g) In November 1936, and after the litigation of Julian vs. Schwartz was finally determined and adjudicated, Barnhart-Morrow Consolidated engaged the firm of Geo. F. Meitner & Co., to bring its books and records up to date giving effect to the transactions pertaining to each of the years 1930, 1931, 1932, 1933, 1934, 1935 and 1936. Such transactions involved the settlement of the account with W. J. Barnhart in the year 1932; gas revenues which were considered constructively received by the company during the years 1933, 1934 and 1935; depreciation which the company sustained on its oil well equipment and general lease equipment for the years 1931 to 1936, all years inclusive; the transactions of Ralph S. Armour, Receiver for the company, in accordance with the petitions for and in

the years in which they were filed and approved by the court and the income from impounded funds in the matter of Julian vs. Schwartz due Barnhart-Morrow Consolidated, in accordance with the judgment rendered by the court in the matter.

(h) In accordance with such engagement the auditors gave effect to such transactions in the years in which they were paid and/or accrued or [28] definitely determined by the court, and pursuant to the resolution passed by the Board of Directors who did not recognize the company's liability to Mr. Hardison for the two notes amounting to \$8,500.00, said auditors cancelled such indtebdness in the year 1931 as of its date of origination in July 1930, reversing the charge to Well No. 17 equipment, thereby eliminating any deduction for depreciation on that amount from July 1930, but inadvertently failed to cancel in 1931 that portion of Mr. Hardison's salary which had been accrued in 1931 but not recognized or paid by the company.

(14) (a) On April 15, 1927 Barnhart-Morrow Consolidated loaned to one Ed. G. Westberg the sum of \$1,000.00 evidenced by note in favor of the company. Subsequently settlement of the note was made by Mr. Westberg through an assignment of a one per cent (1%) interest in a patent pertaining to improvements in the "art of removing oil from oil wells". Such interest in patent was determined to be valueless and authorized by the Board of Directors to be charged off on the books of the company in the year 1936.

(15) (a) In 1937 Barnhart-Morrow Consolidated paid to Hanna and Morton, its attorneys, the sum of \$900.00, covering services rendered by that firm at stockholders and directors meetings; in connection with application filed with the Securities Exchange Commission, pertaining to stock traded on the Los Angeles Stock Exchange and not in connection with any new issue of stock by the taxpayer; in the filing of Answers in the suit of Cargill vs. Barnhart-Morrow, et al., telegrams, messenger service and filing fees, all of which were paid and pertain to its regular business operations and are not in connection with the acquisition of title to any property or [29] organization costs of the taxpayer.

(16) (a) For the year 1937 there was accrued on the corporation's books the sum of \$300.17, being interest from March 15, 1937 to December 31, 1937 on Federal Income and State Franchise Taxes determined as payable on the net income of the taxpayer for the year ending December 31, 1936.

Wherefore, Petitioner prays that this Board may hear the proceeding and determine

(a) What constitutes Petitioner's gross income and net income from its oil wells for the years 1936 and 1937 and in connection therewith the amount of depletion allowance allowable as a deduction therefrom in determining Petitioner's net taxable income.

(b) That the deductions claimed and losses sustained by the Petitioner in the respective years of 1936 and 1937 are allowable deductions from the

gross income of the Petitioner in the respective years of 1936 and 1937 to which they pertain.

(c) That the Petitioner was insolvent and in receivership in the year 1936 and accordingly Petitioner is not liable for surtax on any undistributed profits for the year 1936.

(d) That the Participating Oil Agreements of the Petitioner in Julian Wells Nos. 1, 2 and 3 are direct interests or estates in the proceeds of oil produced from said wells and accordingly allowance for depletion shall be made with respect to the income received thereon, and

(e) For such other and further relief as the Board may deem just and proper. [30]

GEO. F. MEITNER,

C. P. A. O.K.

711 Wright and Callender  
Bldg., 405 So. Hill Street,  
Los Angeles, California

HAROLD C. MORTON,

Attorney O.K.

1126 Pacific Mutual Bldg.,  
523 West Sixth Street, Los  
Angeles, California

Counsel for Petitioner

[Duly Verified.] [31]

**EXHIBIT "A"**

(Copy)

SN-IT-1

Treasury Department  
Internal Revenue Service  
12th Floor  
U. S. Post Office and Court House,  
Los Angeles, California  
Form 1230

Office of  
Internal Revenue Agent in Charge  
Los Angeles Division

IT:LA

PB-90D

Sep 18 1940

Barnhart-Morrow Consolidated,  
1009 Title Guarantee Building,  
**411** West Fifth Street,  
Los Angeles, California

Sirs:

You are advised that the determination of your income tax liability for the taxable year(s) 1936 and 1937 discloses a deficiency of \$48,584.85 as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency mentioned.

Within 90 days (not counting Sunday or a legal holiday in the District of Columbia as the 90th day) from the date of the mailing of this letter, you may file a petition with the United States Board of Tax Appeals for a redetermination of the deficiency.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Internal Revenue Agent in Charge, Los Angeles, California, for the attention of IT:LA:FC. The signing and filing of this form will expedite the closing of your return(s) by permitting an early assessment of the deficiency, and will prevent the accumulation of interest, since the interest period terminates 30 days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully,

GUY T. HELVERING

Commissioner,

By.....

(Signed)

GEORGE D. MARTIN

Internal Revenue Agent in  
Charge.

Enclosures:

Statement.

Form of waiver.

PB:fpc [32]

## STATEMENT

IT:LA  
PB-90D

Barnhart-Morrow Consolidated,  
1009 Title Guarantee Building,  
411 West Fifth Street,  
Los Angeles, California.

Tax Liability For the Taxable Years Ended  
December 31, 1936 and December 31, 1937

	Years	Liability	Assessed	Deficiency
Income tax .....	1936	\$ 32,767.96	None	\$ 32,767.96
Income tax .....	1937	15,816.89	None	15,816.89
<b>Totals .....</b>		<b>\$ 48,584.85</b>	<b>None</b>	<b>\$ 48,584.85</b>

In making this determination of your income tax liability, careful consideration has been given to the report of examination dated May 11, 1939, to your protest dated August 31, 1939, and to the statements made at the conferences held on September 18, 1939, and subsequent dates.

The contention made in your protest that a deduction of \$1,000.00 not claimed in your return is allowable for the taxable year 1936, on account of loss due to worthlessness of a patent in which you had an interest, is denied in the absence of evidence that the patent became worthless in that year.

The contention made in your protest that a deduction of \$16,500.00 not claimed in your return is allowable for the taxable year 1936, as a bad debt due from C. C. Julian, arising from a payment of royalties in the amount of \$16,500.00 made during

the taxable year 1936 to J. A. Smith, is denied. It has not been shown that within the taxable year 1936 you ascertained said amount of \$16,500.00 to be a worthless debt and charged it off as a worthless debt. Section 23(k), Revenue Act of 1936. The payment of the said amount to J. A. Smith did not constitute an ordinary and necessary business expense properly accrued within the taxable year 1936 under the provisions of section 23(a) of the Revenue Act of 1936. [33]

It is determined that you were not insolvent at any time during the period of your receivership in the taxable year 1936 and you are, therefore, not exempt from surtax on undistributed profits under the provisions of section 14 of the Revenue Act of 1936.

If you do not acquiesce in all of the adjustments making up the deficiency indicated, but desire to stop the accumulation of interest on that part of the deficiency resulting from adjustments to which you agree, please fill out the enclosed form of waiver, inserting therein the amount of the deficiency you desire to have assessed at once. The execution of the form for the agreed portion of the deficiency will not deprive you of your right to petition the United States Board of Tax Appeals for a redetermination of the deficiency.

A copy of this letter and statement has been mailed to your representative, Mr. George F. Meitner, 405 South Hill Street, Los Angeles, California, in accordance with the authority contained in the power of attorney executed by you and on file with the Bureau. [34]

## Adjustments to Net Income

Taxable Year Ended December 31, 1936

Net income as disclosed by return (loss).....\$ (11,851.39)

## Additional income and unallowable deductions:

(a) Proceeds from impounded oil sales .....	\$142,989.99	
(b) Additional oil and gas sales.....	13.27	
(c) Equipment rental .....	5,000.00	
(d) Accrued salary cancelled.....	7,000.00	
(e) Accrued interest cancelled.....	391.67	
(f) Repairs disallowed .....	15.01	
(g) Receivership expenses disallowed .....	11,908.53	167,318.47
		_____

Total ..... \$155,467.08

## Additional deductions:

(h) Field overhead expense .....	\$ 45.12	
(i) General and Administrative expenses .....	2,878.76	
(j) Taxes .....	881.47	
(k) Interest accrued .....	1,409.36	
(l) Overriding royalties .....	3,260.94	
(m) Depletion .....	43,089.65	51,565.30
		_____

Net income adjusted ..... \$103,901.78

## Explanation of Adjustments

(a) The amount of \$142,989.99 received during the taxable year from impounded oil sales represents income of the taxable year, which was not included in your return. [35]

(b) Income from oil and gas sales included in your return is understated in the net amount of \$13.27, as follows:

Income from oil sales understated.....	\$ 5.95
Income from dry gas sales understated.....	49.79
<hr/>	
Total .....	\$55.74
Income from wet gas sales overstated.....	42.47
<hr/>	
Net adjustment .....	\$13.27

(c) Rental received on equipment in the amount of \$5,000.00 was not included in your return.

(d) The income reported in your return is increased by \$7,000.00, the amount of salary accrued in 1931 and cancelled by agreement in 1936.

(e) The income reported in your return is increased by \$391.67, the amount of interest accrued in prior years and cancelled in 1936.

(f) The deduction claimed for repairs, materials and supplies, \$373.03, is \$15.01 in excess of the correct amount, \$358.02.

(g) The amount of \$11,908.53 claimed in your return as a deduction on account of receivership expenses is disallowed for the reason that these expenses properly accrued prior to the taxable year. Section 23 of the Revenue Act of 1936.

(h), (i), (j), (k) and (l). These adjustments are made on account of allowable deductions not claimed in your return.

(m) Depletion is allowable under the provisions of sections 23(m) and 114(b)(3) of the Revenue Act of 1936 in the amount of \$4,622.52, which is \$43,089.65 in excess of the amount claimed in your return. [36]

## Computation of Tax

Taxable Year Ended December 31, 1936

## INCOME TAX

## Normal Tax

Taxable net income .....	\$103,901.78
Normal-tax net income .....	\$103,901.78
<b>Normal tax:</b>	
8% of \$ 2,000.00 .....	\$ 160.00
11% of 13,000.00 .....	1,430.00
13% of 25,000.00 .....	3,250.00
15% of 63,901.78 .....	9,585.27
<hr/>	
Total normal tax .....	\$ 14,425.27

## Surtax on Undistributed Profits

Taxable net income .....	\$103,901.78
Less: Normal tax .....	14,425.27
<hr/>	
Adjusted net income .....	\$ 89,476.51
Undistributed net income .....	\$ 89,476.51
<b>Surtax:</b>	
7% of \$ 8,947.65 .....	\$ 626.34
12% of 8,947.65 .....	1,073.72
17% of 17,895.30 .....	3,042.20
22% of 17,895.30 .....	3,936.97
27% of 35,790.61 .....	9,663.46
<hr/>	

[Figures in pencil] : 81476.51

Total surtax .....	\$ 18,342.69
Total normal tax .....	14,425.27
<hr/>	
Total income tax (normal tax and surtax).....	\$ 32,767.96
Income tax assessed (normal tax and surtax):	
Original, account No. 858053 .....	None
<hr/>	
Deficiency of income tax .....	\$ 32,767.96

Adjustments To Net Income -  
Taxable Year Ended December 31, 1937

Net income as disclosed by return.....	\$	432.18
Additional income and unallowable deductions:		
(a) Additional oil and gas sales.....	\$	582.59
(b) Superintendent expense disallowed		1,109.49
(c) Field salaries disallowed.....		277.50
(d) Field overhead expense disallowed		56.93
(e) Legal expense disallowed .....		400.00
(f) Automobile and travel expense disallowed .....		53.76
(g) General and administrative ex- pense disallowed .....		178.55
(h) Miscellaneous operating costs disallowed .....		7.17
(i) Insurance expense disallowed .....		32.47
(j) Taxes disallowed .....		482.62
(k) Depletion disallowed .....		16,163.40
(l) Interest disallowed .....		300.17
(m) Loss from abandonment of well No. 16 disallowed .....		38,984.02
(n) Loss from collapse of casing and tubing disallowed .....		5,628.52
(o) Loss from abandonment of Davis well disallowed .....		116.75
		<hr/>
Total .....		\$ 64,806.12
Additional deductions:		
(p) Depreciation .....		\$2,352.35
(q) Repairs .....		187.92
(r) Royalties .....		446.90
(s) Fuel .....		23.10
		<hr/>
Net income adjusted .....		\$ 61,795.85

[38]

### Explanation of Adjustments

(a) Income from oil and gas sales included in your return is understated in the net amount of \$582.59, as follows:

Income from oil sales understated .....	\$589.14
Income from wet gas sales overstated.....	6.55
Net adjustment .....	<u>\$582.59</u>

(b), (c), (d), (f), (h) and (i). These adjustments are made on account of deductions claimed in your return in excess of the respective amounts shown by your records.

(e) Attorney's fees in the amount of \$250.00 incurred in connection with registration of your capital stock claimed in your return are disallowed as not being deductible under the provisions of section 23 of the Revenue Act of 1936. Attorney's fees in the amount of \$150.00 incurred in connection with the acquisition of K.C.L. properties are likewise disallowed.

(g) This adjustment represents the disallowance, under the provisions of section 24 of the Revenue Act of 1936, of \$69.01 cost of furniture and fixtures claimed as a deduction in your return, and \$109.54 bank collection fees which has been allowed as a deduction for the preceding taxable year (included in adjustment (i) of the preceding taxable year.)

(j) The amount of \$441.00, representing an excessive accrual of Federal capital stock tax is disallowed under the provisions of section 23 of the Revenue Act of 1936. A further disallowance of

\$41.62 is made on account of deductions claimed in excess of the amount shown by your records.

(k) Depletion is allowable under the provisions of sections 23(m) and 114(b)(3) of the Revenue Act of 1936 in the amount of \$56,672.54, and since you claimed the amount of \$72,835.94 as a deduction in your return the amount of \$16,163.40 is disallowed. [39]

(l) The amount of \$300.17 claimed in your return as interest accrued on additional Federal income tax for 1936 is disallowed inasmuch as the liability for additional tax had not been determined or acknowledged. Section 23 of the Revenue Act of 1936.

(m) The amount of \$38,984.02 claimed in your return as loss on abandonment of your interest in well No. 16 is disallowed as not falling within the provisions of section 23 of the Revenue Act of 1936.

(n) The loss claimed in your return on account of collapse of casing and tubing in well No. 16 is excessive in the amount of \$5,628.52.

(o) The loss claimed in your return on account of abandonment of Davis well is excessive in the amount of \$116.75.

(p), (q), (r) and (s). These adjustments represent amounts of deductions allowable in addition to the respective amounts claimed in your return. [40]

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The Bureau of Internal Revenue

## Computation of Tax

Taxable Year Ended November 31, 1937

## INCOME TAX

## Normal Tax

Taxable net income .....	\$ 61,795.85
Less: Dividends received credit .....	11,922.52

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Normal-tax net income .....	\$ 49,873.33
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## Normal tax:

8% of \$ 2,000.00 .....	\$ 160.00
11% of 13,000.00 .....	1,430.00
13% of 25,000.00 .....	3,250.00
15% of 9,873.33 .....	1,481.00

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Total normal tax .....	\$ 6,321.00
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## Surtax on Undistributed Profits

Taxable net income .....	\$ 61,795.85
Less: Normal tax .....	6,321.00

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Adjusted net income .....	\$ 55,474.85
Less: Dividends paid credit .....	6,949.77

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Undistributed net income .....	\$ 48,525.08
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## Surtax:

7% of \$ 5,547.49 .....	\$ 388.32
12% of 5,547.49 .....	665.70
17% of 11,094.97 .....	1,886.14
22% of 11,094.97 .....	2,440.89
27% of 15,240.16 .....	4,114.84

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Total surtax .....	\$ 9,495.89
Total normal tax .....	6,321.00

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Total income tax (normal tax and surtax).....	\$ 15,816.89
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Income tax assessed (normal tax and surtax) :	
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Original, account No. 857823 .....	None
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Deficiency of income tax .....	\$ 15,816.89
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## EXHIBIT "B"

(Copy)

TREASURY DEPARTMENT  
Washington

Jan 30 1936

Office of  
Commissioner of Internal Revenue  
Address reply to  
Commissioner of Internal Revenue  
and refer to  
MT:CST:ECB  
597824

Barnhart-Morrow Consolidated,  
1009 Title Guarantee Building,  
411 West Fifth Street,  
Los Angeles, California

Gentlemen:

Your capital stock tax return, Form 707, filed for the taxable year ended June 30, 1934, and the information submitted in connection therewith have been examined. The evidence discloses that the corporation was not doing business within the meaning of Section 701 of the Revenue Act of 1934, and your claim for exemption is therefor sustained.

It will not be necessary to file capital stock tax returns for this corporation for subsequent years as long as its business is under the control and management of a court, State or Federal liquidating official.

By direction of the Commissioner.

Respectfully,

(Signed)

D. S. BLISS

D. S. Bliss

Deputy Commissioner

cc—Los Angeles, California.

MT:CST:113

[Endorsed]: U. S. B. T. A. Filed Dec. 13, 1940.

[42]

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**[Title of Board and Cause.]**

**ANSWER**

The Commissioner of Internal Revenue, by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, for answer to the petition of the above-named taxpayer, admits and denies as follows:

1 and 2. Admits the allegations contained in paragraphs 1 and 2 of the petition.

3. Admits that the taxes in controversy are income taxes and surtaxes for the years 1936 and 1937; denies the remainder of the allegations contained in paragraph 3 of the petition.

4. Denies allegations of error contained in subparagraphs (a) to (p), inclusive, of paragraph 4 of the petition.

5. (1)(a) Admits that Barnhart-Morrow Consolidated was organized under the laws of the State of California under date of December 24, 1926; de-

nies the remainder of the allegations contained in subparagraph (1)(a) of paragraph 5 of the petition.

[43]

(1)(b) Admits that said Barnhart-Morrow Consolidated keeps its books and records on an accrual basis, and its income tax returns for the years 1936 and 1937 have been filed on the accrual basis in reporting net taxable income; denies the remainder of the allegations contained in subparagraph (1)(b) of paragraph 5 of the petition.

(1)(c) to (16)(a), inclusive. Denies the allegations contained in subparagraphs (1)(c) to (16)(a), inclusive, of paragraph 5 of the petition.

6. Denies each and every allegation contained in the petition not hereinbefore specifically admitted or denied.

Wherefore it is prayed that the determination of the Commissioner be approved.

(S) J. P. WENCHEL,  
Chief Counsel, Bureau of  
Internal Revenue.

Of Counsel:

ALVA C. BAIRD,

Division Counsel.

FRANK T. HORNER,

E. A. TONJES,

Special Attorney, Bureau of  
Internal Revenue.

[Endorsed]: U. S. B. T. A. Filed January 29,  
1941. [44]

[Title of Board and Cause.]

### STIPULATION OF FACTS [45]

It Is Hereby Stipulated and Agreed, by and between the parties hereto, through their respective counsel, that the following facts are true: [46]

#### I

That on November 10, 1931, Lem A. Brunson and Clara A. Brunson were the owners of the certain land described in a lease dated November 10, 1921, wherein the said Brunson and wife are lessors and the Globe Petroleum Company is lessee, which lease was executed and delivered on the date thereof and was recorded on December 9, 1921, in book 121, page 1 of Official Records in the office of the County Recorder of Los Angeles County, California. Said lease is referred to herein as the "Brunson Lease" and a true copy thereof is hereto attached and designated as Exhibit No. 1.

#### II

That on or about June 2, 1922, the said Globe Petroleum Corporation, lessee under said Brunson Lease, executed and delivered a sublease to C. C. Julian as lessee, bearing said date, recorded June 27, 1922, in book 1180, page 252 of Official Records of Los Angeles County, California. Said sublease of June 2, 1922 from the Globe Petroleum Corporation to C. C. Julian is for convenience referred to as the "First Globe Lease" and a true copy thereof is hereto attached and designated as Exhibit No. 2.

### III

That on or about June 17, 1922, said C. C. Julian joined therein by his wife, Mary Julian, executed a certain document entitled "Assignment of Lease" to the Citizens Trust and Savings Bank, a corporation (now Citizens [47] National Trust and Savings Bank and referred to herein as **Citizens Bank**), with the written approval endorsed thereon by the Globe Petroleum Corporation; that said assignment was recorded August 4, 1922, in book 1223, at page 371 of Official Records of Los Angeles County, California. A copy of said assignment is attached hereto and designated as Exhibit No. 3. Said assignment for convenience will be referred to as "Well No. 1 Assignment".

That said Citizens Bank at or about the time of said assignment, executed a document entitled "Declaration of Trust", a copy of which is attached hereto and designated as Exhibit No. 4.

### IV

That following the execution and delivery of said Well No. 1 Assignment from C. C. Julian and Mary Julian, his wife, to said Citizens Bank and of said document entitled "Declaration of Trust", to wit: between June 17, 1922 and July 15, 1922, said C. C. Julian at and in the State of California executed and delivered to many persons as purchasers thereof documents entitled "Well No. 1 Participating Oil Agreements". Said participating oil agreements were known as and are hereby referred to as "Regular Well No. 1 Participating Oil Agree-

ments". That said "Regular Well No. 1 Participating Oil Agreements" so executed, sold [48] and delivered by said C. C. Julian are in the form attached hereto and designated as Exhibit No. 5. Said "Regular Well No. 1 Participating Oil Agreements" were substantially identical each to the other, except for the date, the number, the name of the purchaser and the amount of the fractional interest, which fractional interests were, as stated in said document, divided into 1750 parts. That all of said 1750 parts as defined in and as represented by said "Regular Well No. 1 Participating Oil Agreements" were issued, sold and delivered by said C. C. Julian to the purchasers thereof. That said 1750 parts relate to the proceeds of all of 49% of the oil produced from the oil well drilled on the land described therein, referred to and designated as Oil Well No. 1.

That said C. C. Julian also in the year 1922 executed, sold and delivered to numerous persons as purchasers thereof participating oil agreements in writing known as "Special Well No. 1 Participating Oil Agreements" in the form attached hereto, hereby referred to as Exhibit No. 6. Said "Special Well No. 1 Participating Oil Agreements" were substantially identical each to the other, except for the date, the number, the name of the purchaser and the amount of the fractional interest therein specified. All of said fractional interests aggregated 455 parts, each part being [49] 1/35th of one per cent of a certain residue of the proceeds of the production of said Oil Well No. 1, as defined in said "Special Well No. 1 Participating Oil Agreements". That all of

said 455 parts as defined in said "Special Well No. 1 Participating Oil Agreements" were sold and delivered by said C. C. Julian and relate to all of the proceeds of 13% of the oil produced from said Well No. 1.

That the purchasers of said participating oil agreements paid to said C. C. Julian \$100.00 per each 1/1750th part of 70% or the residue of the proceeds of production from said Well No. 1 and \$100.00 per each 1/35th of 1% of the residue of the production from said Well No. 1, as defined in said documents.

That said Well No. 1 Participating Oil Agreements were acknowledged and at least one of said agreements was recorded prior to January 1, 1924, in the office of the County Recorder of Los Angeles County, California.

That said C. C. Julian also in 1922 executed, sold and delivered to various persons documents purporting to be assignments of a total of 8% of the production of said Well No. 1; that said purported assignments of each per cent of said 8% of the production thereof so assigned by said Julian was in the form hereto attached as Exhibit No. 7. [50]

That following the execution and delivery by C. C. Julian of said Regular and Special Well No. 1 Participating Oil Agreements and said per cent assignments to the various purchasers thereof, said Julian, to wit, in the year 1922, drilled on the land embraced in said Well No. 1 assignment to said Citizens Bank an oil well known as Well No. 1 down to what is known as the "Meyer Sand" under-

lying the surface of all of the land described in said Brunson Lease, at a depth of approximately 4600 feet. Said Well No. 1 was completed and placed on production and began the production of oil from said premises on or about March 26, 1923, and has since produced and is still producing oil therefrom.

## V

That under date of September 5, 1922, said C. C. Julian and Mary Julian, his wife, with written approval endorsed thereon by the Globe Petroleum Corporation, executed a certain document entitled "Assignment of Lease" to said Citizens Bank; that said assignment was recorded on October 5, 1922, in book 1382, page 347 of Official Records of Los Angeles County, California. A copy of said assignment is hereto attached as Exhibit No. 8. For convenience said assignment will be referred to as "Well No. 2 Assignment."

That said Citizens Bank at or about the time of said assignment, executed a document entitled "Declaration of Trust", a copy of which is hereto attached as Exhibit No. 9. [51]

## VI

That following the execution and delivery of said Well No. 2 Assignment from C. C. Julian and Mary Julian, his wife, to said Citizens Bank and of said document entitled "Declaration of Trust"; to wit, between September 5, 1922 and December 31, 1922, said C. C. Julian at and in the State of California executed and delivered to many persons as pur-

chasers thereof documents entitled "Well No. 2 Participating Oil Agreements", relating to fractional interests in 70% of the net proceeds of the production of an oil well to be drilled on the premises described in said Well No. 2 Assignment. Said Participating oil agreements were known as and are hereby referred to as "Regular Well No. 2 Participating Oil Agreements". That said "Regular Well No. 2 Participating Oil Agreements" so executed, sold and delivered by said C. C. Julian are in the form hereto attached as Exhibit No. 10. Said "Regular Well No. 2 Participating Oil Agreements" were substantially identical each to the other, except for the date, the number, the name of the purchaser and the amount of the fractional interest, which fractional interests were, as stated in said documents, divided into 1750 parts. That all of said 1750 parts, as defined in and as represented by said "Regular Well No. 2 Participating Oil Agreements" were issued, sold and delivered by said C. C. Julian to [52] the purchasers thereof. That said 1750 parts relate to the proceeds of all of 49% of the oil produced from the oil well drilled on the land described therein, referred to and designated as Oil Well No. 2.

That said C. C. Julian also at the same time, that is to say, between September 5, 1922 and December 31, 1922, executed, sold and delivered to numerous persons as purchasers thereof participating oil agreements in writing known as "Special Well No. 2 Participating Oil Agreements" in the form attached hereto, hereby referred to and for identification designated as Exhibit No. 11. That said "Special Well No. 2 Participating Oil Agreements" were substan-

tially identical to the other, except for the date, the number, the name of the purchaser and the amount of the fractional interest therein specified. All of said fractional interests aggregated 455 parts, each part being 1/35th of one per cent of a certain residue of the proceeds of the production of said Oil Well No. 2, as defined in said "Special Well No. 2 Participating Oil Agreements". That all of said 455 parts as defined in said "Special Well No. 2 Participating Oil Agreements" were assigned, sold and delivered by said C. C. Julian and they relate to all of the proceeds of 13% of the oil produced from said Well No. 2.

That the purchasers of said Participating Oil Agreements paid to said C. C. Julian \$100.00 per each 1/1750th [53] part of 70% of the residue of the proceeds of production from said Well No. 2 and \$100.00 per each 1/35th of 1% of the residue of the production from said Well 2 as defined in said documents.

That said Well No. 2 Participating Oil Agreements were acknowledged and at least one was recorded prior to January 1, 1924, in the office of the County Recorder of Los Angeles County, California.

That said C. C. Julian also in 1922 executed, sold and delivered to various persons documents purporting to assign to various persons a total of 8% of the production of said Well No. 2; that a true form of each of said purported assignments of each per cent or fraction of said 8% of the production thereof so assigned by said Julian is hereto attached as Exhibit No. 12.

That following the execution and delivery by C. C. Julian of said Regular and Special Well No. 2 Participating Oil Agreements and said per cent assignments to the various purchasers thereof, said Julian, to wit, in the year 1922 drilled on the land embraced in said Well No. 2 Assignment to said Citizens Bank an oil well known as Well No. 2 down to said "Meyer Sand". Said well No. 2 was completed and placed on production and began the production of oil from said premises on or about September 9, 1923, and has since produced and is still producing oil therefrom. [54]

## VII

That said Citizens Bank under date of February 5, 1923, executed a document entitled "Declaration of Trust", a copy of which is hereto attached and is hereby referred to as Exhibit No. 14.

## VIII

That following the execution of said document entitled "Declaration of Trust", to wit: prior to August 17, 1923, said C. C. Julian at and in the State of California executed and delivered to many persons as purchasers thereof documents entitled "Well No. 3 Participating Oil Agreements" relating to fractional interests in 70% of the net proceeds of the production of oil well to be drilled on the premises described in said Well No. 3 Assignment. Said participating oil agreements were known as and are hereby referred to as "Regular Well No. 3 Participating Oil Agreements". Said "Regular Well

No. 3 Participating Oil Agreements" so executed, sold and delivered by said C. C. Julian are in the form hereto attached as Exhibit No. 15. That said "Regular Well No. 3 Participating Oil Agreements" were substantially identical each to the other, except for the date, the number, the name of the purchaser and the amount of the fractional interest, which fractional interests were, as stated in said document, divided into 1750 parts. That all of said 1750 parts as defined in and represented by said "Regular Well No. 3 Participating Oil [55] Agreements" were sold and delivered by said C. C. Julian to the purchasers thereof; that said 1750 parts relate to the proceeds of all of 49% of the oil produced from the oil well drilled on the land described therein, referred to and designated as Oil Well No. 3.

That said C. C. Julian also at the same time, that is to say, prior to August 17, 1923, executed, sold and delivered to numerous persons "Special Participating Oil Agreements" in writing known as "Special Well No. 3 Participating Oil Agreements", in the form hereto attached, hereby referred to as Exhibit No. 16. That said "Special Well No. 3 Participating Oil Agreements" were substantially identical each to the other, except for the date, the number, the name of the purchaser and the amount of the fractional interest therein specified. All of said fractional interests aggregated 735 parts, each part being 1/35th of one per cent of a certain residue of the proceeds of the production of said Oil Well No. 3 as defined in said "Special Well No. 3 Participat-

ing Oil Agreements". That all of said 735 parts as defined in said "Special Well No. 3 Participating Oil Agreements" were assigned, sold and delivered by said C. C. Julian and they relate to all of the proceeds of 21% of all the oil produced from said Well No. 3.

That the purchasers of said participating oil agreements paid to said C. C. Julian \$100.00 per each 1/1750th [56] part of 70% of the residue of the production from said Well No. 3 and \$100.00 per each 1/35th of 1% of the residue of the production from said Well No. 3, as defined in said documents.

That said Well No. 3 Participating Oil Agreements were acknowledged and at least two were recorded prior to January 1, 1924, in the office of the County Recorder of Los Angeles County, California.

That following the execution and delivery by C. C. Julian of said Regular and Special Well No. 3 Participating Oil Agreements, said Julian, to wit, in the year 1923, drilled on the premises embraced in said Well No. 3 Assignment to said Citizens Bank an oil well known as Well No. 3 down to said "Meyer Sand." Said Well No. 3 was completed and placed on production and began the production of oil from said premises on or about June 25, 1923, and has since produced and is still producing oil therefrom.

## IX

That said Wells Nos. 1, 2, and 3, upon their completion in said Santa Fe Springs oil field, for periods of time produced oil and gas in large quantities. Production of said wells was under the

supervision and direction of said C. C. Julian. The production from said wells gradually declined and in the year 1924 had ceased to flow naturally and future production therefrom would require mechanical methods of production. The manner in which the production from said wells was sold and the distribution of the proceeds therefrom is hereinafter set forth.

## X

That on March 26, 1923, said Globe Petroleum Corporation, as lessor, executed another sublease to said C. C. Julian, as lessee, which was recorded April 23, 1923, in book 2129, page 49 of Official Records of Los Angeles County, California. That said lease of March 26, 1923, from said Globe Petroleum Corporation, as lessor, to said C. C. Julian, as lessee, is herein referred as the "Second Globe Lease." A true copy thereof is attached hereto and is hereby referred to as Exhibit No. 17.

## XI

That under date of April 21, 1923, said C. C. Julian, and Mary Julian, his wife, and John F. Beyer and [58] Loraine Beyer, his wife, and J. H. Roth, assigned to said Citizens Bank all their right, title and interest in and to said Second Globe Lease and in and to certain other oil leases not involved in this action, which assignment is hereinafter for convenience referred to as "Well No. 11 Assignment." That a true copy thereof is hereto attached as Exhibit No. 18. That said document was not recorded.

That said Citizens Bank on or about November 19, 1923, executed a document entitled "Declaration of Trust", a copy of which is hereto attached, designated as Exhibit No. 19.

## XII

That following the execution of said "Well No. 11 Assignment" by said Julian, Beyer and Roth to said Citizens Bank, and following the execution of said document entitled "Declaration of Trust", said Julian, Beyer and Roth executed and delivered to many persons as purchasers thereof documents purporting to assign interests in the production of Oil Wells Nos. 11 and 12, entitled "Participating Oil Agreements", relating to fractional interests in 50% of the net proceeds of the production of wells to be drilled on the premises of the production of wells to be drilled on the premises described in said assignment. Said participating oil agreements were known as "Wells No. 11, 12 and Pico Participating Oil Agreements". All of said "Wells No. 11, 12 and Pico Participating Oil Agreements" were substantially identical each to the other, except for the date, the number, the name of the purchaser and the amount [59] of the fractional interest, which fractional interests were, as stated in said document, divided in 7500 parts. That all of said 7500 parts as defined in said "Wells No. 11, 12 and Pico Participating Oil Agreements" were sold and delivered by C. C. Julian to the purchasers thereof. A true copy of said "Wells No. 11, 12 and Pico Par-

ticipating Oil Agreements" is attached hereto as Exhibit No. 20.

That the purchasers of said fractional interests paid to said C. C. Julian, John F. Beyer and J. H. Roth, doing business as C. C. Julian & Company, \$100.00 per each 1/7500th part of 50% of the residue (as defined in said document) of the production from wells to be drilled on the land described in said Second Globe Lease.

### XIII

That in addition to said 50% of the residue of the production from premises described in said Second Globe Lease said Julian, Beyer and Roth executed, sold and delivered to various purchasers thereof documents purporting to assign interests in the production of Wells 11 and 12 by the assignment of one per cents or portions of one per cents thereof in the form hereto attached, hereby referred to as Exhibit No. 21.

### XIV.

That Well No. 11 mentioned and referred to in said Participating Oil Agreements executed and delivered by said Julian, Beyer and Roth was drilled on the premises [60] described in said Second Globe Lease in the year 1923 under said Participating Oil Agreements made by said Julian, Beyer and Roth and their assignments of percents in the production thereof, down to said "Meyer Sand" underlying said premises, and was completed and placed on production and began the production of oil in 1923 and has produced oil and gas intermittently since.

That Well No. 12 mentioned and referred to in said Participating Oil Agreements executed and delivered by said Julian, Beyer and Roth was also drilled on the premises described in said Second Globe Lease and for a time produced some oil, but said Well No. 12 was abandoned in the year 1927 and since then has never at any time produced any oil or other substances.

That the other property described in said "Wells No. 11, 12 and Pico Participating Oil Agreements" is not any part of the premises described in said Second Globe Lease.

## XV.

That on or about January 15, 1925, C. C. Julian, John F. Beyer and J. H. Roth, as parties of the first part, and D. R. Morrow and W. J. Barnhart, as parties of the second part, executed a certain document, a copy of which document is hereto attached, hereby referred to, and marked Exhibit No. 22.

That on or about April 16, 1925, Said D. R. Morrow [61] and W. J. Barnhart executed a purported assignment to Barnhart-Morrow, Inc. On or about January 19, 1927, said Barnhart-Morrow, Inc. executed a purported assignment to Barnhart-Morrow Consolidated, a California corporation. Said assignments appear on said Exhibit No. 22.

Under date of August 20, 1929, said Barnhart-Morrow Consolidated, by W. J. Barnhart as its president, wrote a letter addressed to C. C. Julian, a copy of which is hereto attached, hereby referred to and for identification marked Exhibit No. 23.

Under date of August 24, 1929, C. C. Julian wrote a letter addressed to Barnhart-Morrow Consolidated, a copy of which is hereto attached, hereby referred to and for identification marked Exhibit 24.

Under date of September 29, 1929, Barnhart-Morrow Consolidated, by W. J. Barnhart as its president, wrote a letter addressed to W. J. Wellman, a copy of which is hereto attached, hereby referred to and for identification marked Exhibit No. 25.

Said agreement and modifications thereof described in this paragraph relating to the operations of Barnhart and Morrow and Barnhart-Morrow Consolidated, will be for convenience referred to as the "Barnhart-Morrow Operating Agreement."

[62]

## XVI.

That on March 9, 1928, United Oil Well Supply Company, Wm. B. Himrod and W. W. Hyams, and Lem A. Brunson and his wife, entered into a purported lease with one W. J. Barnhart, as lessee; that said purported lease was recorded on August 6, 1928, in book 7274, page 1 of official records of Los Angeles county, California. That a copy of said purported lease is designated as Exhibit No. 26. That said lease is referred to in the pleadings and is herein and hereafter for convenience referred to as the "United Lease".

## XVII.

That thereafter, and on or about September 28, 1928, by a document entitled "Assignment of a Portion of Leased Premises" and recorded in book

7374, page 290 of official records of Los Angeles county, California, W. J. Barnhart, joined therein by his wife, Elsie D. Barnhart, executed a purported assignment to C. C. Julian, a copy of which assignment is hereto attached to Exhibit No. 27.

The exception in said documents describes the property on which Well No. 16 hereafter referred to was drilled.

### XVIII.

That under date of October 31, 1928, by document entitled "Assignment", which was recorded December 27, 1938, in book 7397, page 175 of official records of Los Angeles county, California, said A. L. Jameson, joined [63] therein by his wife, executed a purported assignment to the Santa Fe Springs Oil Company, a corporation. A copy thereof is marked as Exhibit No. 28.

That subsequent to said purported assignment to said Santa Fe Springs Oil Company by said A. L. Jameson and wife, said Santa Fe Springs Oil Company drilled an oil well on the land described in said Well No. 3 assignment from C. C. Julian to said Citizens Bank referred to in paragraph ..... hereof. The well so drilled by said Santa Fe Springs Oil Company is known as Well No. 17. It was drilled to a depth of 7000 feet or thereabouts, but did not produce from said depth.

That a document entitled "Operating Agreement", dated October 24, 1928, was executed by said C. C. Julian and A. L. Jameson, a copy of which is hereto attached, hereby designated as Exhibit No. 29.

That on July 9, 1930, a document bearing said date was executed by said Santa Fe Springs Oil Company, and W. J. Barnhart, a copy of which is hereto attached as Exhibit No. 30.

That thereafter, a document dated July 30, 1930, entitled "Operating Agreement", was executed by W. J. Barnhart and Barnhart-Morrow Consolidated, a corporation, a copy of which is marked Exhibit No. 31.

That thereafter said Barnhart-Morrow Consolidated operated said Well No. 17 and placed the same on production from said "Meyer Sand" and has since continued to operate said Well No. 17 and received the production therefrom until said Well No. 17 was placed in the hands of the receiver appointed in the action of Julian v. Schwartz. That said Well No. 17 is still producing oil.

## XIX.

That said W. J. Barnhart, under date of October 20, 1928, executed an assignment to the Italo Petroleum Corporation of America of a portion of the premises described in the Second Globe Lease and included in the premises described in the assignment of said Second Globe Lease by C. C. Julian and said Beyer and Roth to the Citizens Bank hereinbefore referred to, upon which Well No. 11 was drilled. Said Italo Petroleum Corporation thereafter drilled three wells known as Italo No. 1, No. 2, and No. 3.

## XX.

That under date of September 28, 1928, said W. J. Barnhart and said Barnhart-Morrow Consolidated executed a certain document entitled "Operating Agreement", a copy of which is hereto attached, hereby referred to and marked Exhibit No. 32.

That said operating agreement, Exhibit No. 32, from Barnhart-Morrow Consolidated was recorded December 7, 1928, in book 7361, page 63 of official records of Los Angeles county, California.

That on the same date, and in the same place, there [65] was recorded a purported assignment by W. J. Barnhart and wife, executed by them on September 28, 1928, to Wm. M. Cady, of all rights of said W. J. Barnhart as reserved in said so-called operating agreement between said W. J. Barnhart and Barnhart-Morrow Consolidated, a copy of which is marked Exhibit No. 33.

That said Barnhart-Morrow Consolidated, subsequent to September 28, 1928, entered on the land described in "Well No. 2 Assignment" made by C. C. Julian to said Citizens Bank, and drilled thereon a certain oil well which is commonly known as Well No. 16 and commenced and continued to produce oil through said Well No. 16 from said "Meyer Sand" and until the appointment of receivers in Julian v. Schwartz, hereafter referred to, received the production of said Well No. 16.

## XXI.

Under date of September 28, 1928 C. C. Julian, W. J. Barnhart, and Barnhart-Morrow Consolidated executed a document, for convenience described as an option with respect to Well No. 16, providing that upon the payment to said Julian of \$2,500.00 said well need not be drilled below 5,000 feet, photostatic copy of which is marked Exhibit No. 34.

That on or about January 13, 1930 said \$2,500.00 was paid by Barnhart-Morrow Consolidated to C. C. Julian, the receipt for which was endorsed upon said document dated September 28, 1928, same being marked Exhibit No. 34. [66]

## XXII.

That on or about July 25, 1929, Wm. M. Cady executed a document entitled "Assignment of Agreement" to James B. Boyle, copy of which is hereto attached, marked Exhibit No. 35. (Same refers to the interest of said Cady in Well No. 16).

That on or about November 30, 1931 Wm. M. Cady and his wife executed a document entitled "Assignment" to J. A. Smith, to which document said James B. Boyle and his wife executed a consent, all of which appears from said assignment, Exhibit No. 35a. Said assignment from Cady to Smith conveyed among other things all interest of said Cady in Well No. 16 and a right of accounting of oil and gas produced therefrom.

That on or about November 30, 1931, Messrs. Wheat and Strong executed an assignment to J. A.

Smith, copy of which is hereto attached, marked Exhibit No. 36.

### XXIII.

That said Well No. 16 was completed at a depth of less than 5,000 feet (pursuant to said option of September 28, 1928, and the payment by Barnhart-Morrow Consolidated of \$2,500.00 (as hereinbefore described in Paragraph XXI hereof) and said well No. 16 produced from 83-1/3% of the production the sum of \$80,000.00 up to May 1930. Said C. C. Julian, by letter dated May 15, 1930, copy of which is hereto marked as Exhibit No. 37, directed Barnhart-Morrow Consolidated to pay to one H. B. Flesher the proceeds from [67] Well No. 16, payable to C. C. Julian for his interest in said Well No. 16 (being the same interest which had theretofore been assigned to said Cady by instrument dated September 28, 1928, being Exhibit No. 33).

That on or about July 18, 1930, the Barnhart-Morrow Consolidated advised C. C. Julian of claims of James B. Boyle to such moneys from Well No. 16, all as set forth in a copy of a written communication bearing said date, marked Exhibit No. 38.

Under date of July 28, 1930 C. C. Julian delivered to Barnhart-Morrow Consolidated a written document bearing said date, copy of which is hereto marked as Exhibit No. 39, which for convenience is referred to as the "Indemnity Agreement."

After receiving said Indemnity Agreement, Barnhart-Morrow Consolidated proceeded to pay said Flesher the sum of \$16,500.10 as proceeds of said

Well No. 16, payable after Barnhart-Morrow Consolidated had received the sum of \$80,000.00. To February 28, 1931 the total accruals to such interest payable (either to Boyle or Flesher) from said Well No. 16 amounted to \$22,672.63. No other payments were made as and for said interest in Well No. 16 until after the termination of the litigation here and now referred to.

#### XXIV.

In or about the year 1929 one Garliepp obtained a judgment against C. C. Julian in the State of California [68] in the amount of \$10,925.98. Said Garliepp caused execution to be issued against all the properties and wells hereinbefore described and caused an execution sale to be had of the same, at which sale one R. L. Mack became the purchaser. Said purchaser conveyed whatever interest he may have acquired by deed to one W. A. Schwartz. W. A. Schwartz thereupon claimed to be the owner of the wells hereinbefore described except for the land-owners' royalty interests.

Thereupon, and on or about January 1931, said C. C. Julian commenced an action in the Superior Court of the State of California in and for the County of Los Angeles, entitled "C. C. Julian vs. W. A. Schwartz", No. 315345, to restrain said Schwartz from taking possession of said wells or any of them. Said Schwartz thereupon filed a cross-complaint in said action, claiming to be the owner of said wells by reason of said execution sale and claiming that the holders of participating oil agree-

ments and percentage assignments had no interest in said wells, and claiming further that Barnhart-Morrow Consolidated had no interest therein. Such claims appear more particularly from a copy of the cross-complaint of said W. A. Schwartz filed in said action, a copy of which is made Exhibit No. 40 herein.

The holders of participating oil agreements in said Wells 1, 2, 3 and 11, by and through their agents or trustees, [69] Messrs. Redfield, Foster and Penn, filed a cross-complaint in said case of Julian v. Schwartz, wherein they claim to be the owners of the interest assigned to them, and further claim to be the owners of the production of certain other wells which had been drilled on premises covered by the Brunson lease. The claim of holders of participating oil agreements so asserted in their said cross-complaint appear more particularly from a copy of their cross-complaint, a copy of which is marked Exhibit No. 41, hereof.

## XXV.

In said case of Julian v. Schwartz, on or about March 19, 1931, David H. Cannon and Charles F. Allison were appointed receivers to take charge of and operate the oil wells upon the Brunson property, including said Wells 1, 2, 3 and 11, by order of court, copy of which is marked Exhibit No. 41A hereto. Thereafter, on April 30, 1931, said Charles F. Allison was named sole receiver for the same purposes pursuant to order, copy of which is hereto attached, marked Exhibit No. 42. Said Cannon

and Allison, and after his appointment as sole receiver, said Allison had possession of said wells, operated the same under the direction of the court in said action of Julian v. Schwartz pursuant to said orders. Thereafter, and on or about March 23, 1932, said Allison was removed as receiver by order of Court, and in his place and stead F. E. Foster and J. A. Smith were appointed trustees to operate said wells during [70] the pendency of the action in accordance with an order bearing date March 23, 1932, copy of which is hereto attached as Exhibit No. 43. Thereafter said F. E. Foster resigned his position created under said order of March 23, 1932, and C. L. Olson was by order of court appointed as successor to said F. E. Foster. Said Foster and Smith, and after the substitution of said Olson for Foster, said Olson and Smith, remained in possession of said wells and operated the same throughout the pendency of said case of Julian v. Schwartz. Said case of Julian v. Schwartz was decided by the Superior Court on or about September 7, 1933, and findings of fact and judgment made by said Superior Court, copies of which are marked Exhibit No. 44 and Exhibit No. 45 herein. Appeals were taken from said judgment of the Superior Court by said Schwartz and by Messrs. Redfield, Foster and Penn, acting on behalf of the holders of participating oil agreements, which said appeal was thereafter and on or about August 28, 1936, determined by a decision of the District Court of Appeal of the State of California reported in 16 Cal. App. (2d), page 310.

A petition to have the Supreme Court of the State of California hear said case of Julian v. Schwartz after decision by said District Court of Appeal, was by the said Supreme Court denied and said case finally determined in accordance with said opinion of the District Court of Appeal, on October 28, 1936. [71]

## XXVI.

During the pendency of the appeals in the case of Julian v. Schwartz, the Supreme Court of the State of California granted a supersedeas staying execution of the judgment without requiring a bond from appellants (see Julian v. Schwartz, 2 Cal. (2d) 280).

## XXVII.

After the final termination of said litigation Julian v. Schwartz, J. A. Smith, successor to Cady and Boyle of the one-half interest in said Well No. 16, presented to Barnhart-Morrow Consolidated claim for one-half of the funds accruing from production of well No. 16 after the receipt by Barnhart-Morrow of \$80,000.00, and said J. A. Smith demanded an accounting therefor (which sums included the \$16,500.10 paid to H. E. Flesher on the Indemnity Agreement of C. C. Julian as set forth in paragraph XXIII of this stipulation). Barnhart-Morrow Consolidated conceded that the payments theretofore made to Flesher were made in error and paid said sums to J. A. Smith pursuant to said demand. Said C. C. Julian had died in the year 1934 and left no estate, and Barnhart-Morrow Consolidated wrote off the sum of \$16,500.10 in said

year 1936, in which the sum was paid to J. A. Smith. A copy of said demand is attached as Exhibit No. 45-A.

### XXVIII.

Barnhart-Morrow Consolidated quitclaimed Well No. 16 and the premises in which the same was located to J. A. Smith on or about December 20, 1937, by quitclaim deed, [72] copy of which is marked Exhibit No. 46.

Said quitclaim was pursuant to resolution of the board of directors of Barnhart-Morrow Consolidated, copy of which is attached as Exhibit No. 47.

### XXIX.

That in addition to the operation by Barnhart-Morrow Consolidated of Julian Wells Nos. 1, 2, 3, 11, 16 and 17 located in the Santa Fe Springs Oil District in Los Angeles County, of the State of California, Barnhart-Morrow Consolidated operated oil wells in Kern County, California, known as K.C.L. Well No. 1, K.C.L. Well No. 2, K.C.L. Well No. 3, and K.C.L. Well No. 4, as lessee, from January 15, 1937, throughout the remainder of the year 1937.

### XXX.

That the cash distributed to Barnhart-Morrow Consolidated and Ralph S. Armour, receiver for Barnhart-Morrow Consolidated, by the co-trustees in the matter of Julian v. Schwartz in the year 1936 was in accordance with court order dated July 23, 1934, which court order was ineffective during pendency of the appeal in said cause of action, but

became effective on October 28, 1936, when the matter was finally determined and adjudicated. That the amount of cash so distributed to Barnhart-Morrow Consolidated in the year 1936 was \$112,000.00 and to Ralph S. Armour, receiver for Barnhard-Morrow Consolidated in the year 1936 was \$17,852.13. A copy of said order of July 23, 1934 is attached hereto as Exhibit No. 47-A. [73]

### XXXI.

That after said judgment in said cause of action of Julian v. Schwartz became final, the said trustees ordered a final audit and report to be made of their accounts and records and that such audit was made by Geo. F. Meitner and Co., who rendered their audit report under date of February 9, 1937. That the original report of said audit made by said Geo. F. Meitner and Co. was filed with the court subsequently thereafter. A copy of said report is attached hereto as Exhibit No. 48.

### XXXII.

That in February 1937 a further distribution of funds held by the co-trustees was ordered by the Court, and of the amount so ordered to be distributed, Barnhart-Morrow Consolidated reecived the sum of \$63,000.00, and on October 21, 1937 the sum of \$58,037.94 was paid to Barnhart-Morrow Consolidated.

### XXXIII.

That on August 13, 1937 a conference was held in Washington, D. C. by Geo. F. Meitner, attorney in

fact for the said co-trustees, with representatives of the Treasury Department relative to protest filed with the Treasury Department against the proposed assessments against said co-trustees, and at which hearing agreement was signed to the effect that no income tax liability for the years 1931 to 1936 would be assessed against the co-trustees, but that the recipients of the funds distributed by the co-trustees are liable for income taxes on the funds so distributed for the year or years in which distribution is made to them. Said agreement is Exhibit No. 49. That pursuant to said agreement so filed with the Treasury Department, said auditors, Geo. F. Meitner and Co., made their final audit and issued their report in connection therewith on September 22, 1937, and the original of said audit report was filed with the court in said cause of action of Julian v. Schwartz. A copy of said report is attached hereto as Exhibit No. 49-A.

That on October 19, 1937 the Court made its order approving account of co-trustees and directing co-trustees to distribute funds and assign accounts. Said order is Exhibit No. 50.

#### XXXIV.

That at the commencement of said action of Julian v. Schwartz, and the appointment of a receiver therein, instructions of the Court were given to the effect that proper records shall be kept with respect to the income and operating cost of each of the oil wells involved separately. That such records were kept by the co-trustees and that the income and

operating cost of each of the oil wells involved are separately shown in the audit reports filed with the Court in said action, which reports are Exhibits Nos. 48 and 49-A herein.

### XXXV.

That on or about July 29, 1931, in an action brought in the Superior Court in and for the County of Los Angeles, [75] known as case No. 325061, by D. R. Morrow, as plaintiff v. Barnhart-Morrow Consolidated, a corporation, and Guy L. Hardison and W. J. Barnhart under date of July 21, 1931, Ralph S. Armour was appointed receiver for the said Barnhart-Morrow Consolidated (Exhibit 50-A). That the said cause of action was filed in the Superior Court by the said D. R. Morrow for an accounting of the affairs of the corporation; for an accounting to the corporation by W. J. Barnhart, General Manager, and Guy L. Hardison, President of the corporation, for any and all profits, including secret profits; and for unlawful payments as set forth in the complaint; for contesting unlawful and excessive salaries paid to said Barnhart and Hardison; for their removal as officers of the corporation; and among other things set forth in the complaint, for the appointment of a receiver to take charge of the affairs and assets of the corporation, pendente lite (Exhibit 50-B).

### XXXVI.

That the said Ralph S. Armour, receiver for the corporation in said cause of action, was never in complete charge nor had complete control of all of

the assets of the corporation, since the oil properties at Santa Fe Springs, which said Barnhart-Morrow Consolidated had been operating prior to the appointment of receivers in the matter of C. C. Julian v. Schwartz, were then in control and being operated by such receivers under orders of the court [76] issued in said cause of action.

A schedule showing balance sheets of Barnhart-Morrow Consolidated, as per its books for the years 1930 to 1935, is hereto attached, marked Exhibit No. 51. Referring to said balance sheets, the items under the heading "Capital Assets" (except the items pertaining to the Long Beach Hartley Well and Office furniture and fixtures) were not in the possession of Barnhart-Morrow Consolidated from the time of the appointment of the receivers and/or trustees in the case of Julian v. Schwartz in 1931 until the final determination of that litigation in October 1936, but, on the contrary, said receivers and/or trustees had possession of the same pursuant to court orders in said action, and all of said assets were claimed by said Schwartz and by the holders of Participating Oil Agreements as asserted in said action.

### XXXVII.

That pursuant to income tax returns and/or amendments thereto filed with the Treasury Department in Washington, D. C., and in connection with proposed additional assessments against the Barnhart-Morrow Consolidated for the years 1930, 1933 and 1934, and hearing had in Washington on August 13, 1937 relative to the proposed assessment for the

said years above mentioned, the net income or losses of Barnhart-Morrow Consolidated herein for each of the respective years were determined as shown below: [77]

Year	Net Income or (Loss)*
1930 Net income .....	\$ 3,175.54
1931 Net Loss .....	(90,116.67)*
1932 Net Loss .....	( 5,213.85)*
1933 Net Income .....	666.27
1934 Net Loss .....	( 2,516.00)*
1935 Net Loss .....	( 6,063.64)*

### XXXVIII.

None of the income impounded by the co-trustees in the matter of Julian v. Schwartz was considered as income to Barnhart-Morrow Consolidated until released to it. That in 1933 there was released for the account of Barnhart-Morrow Consolidated to J. A. Smith, and in years subsequent thereto, pursuant to stipulation filed with the Court in 1933, gas revenues produced by Julian Wells Nos. 1, 2, 3 and 11, accruing to Barnhart-Morrow Consolidated, and which gas revenues pursuant to hearing held in Washington, D. C., on August 13, 1937, were determined to be income to Barnhart-Morrow Consolidated as having been constructively received by it in the year 1933 and in the years subsequent thereto. There was deducted from the income so considered as having been constructively received by the Barnhart-Morrow Consolidated, depreciation on the tangible equipment of the oil wells and other tangible lease equipment, which wells and other lease equipment were then being operated and/or used

by the co-trustees in the matter of Julian v. Schwartz. In addition to the depreciation so deducted, there was also deducted and allowed business expenses paid and accrued, [78] including legal fees and receivership expenses of Ralph S. Armour, receiver for the corporation. The receivership expenses so allowed, were allowed as deductions in and for the years in which they were definitely determined and approved by the Court in said cause of action No. 325061 wherein the said Ralph S. Armour was receiver.

#### XXXIX.

On November 12, 1936, Ralph S. Armour, receiver for said Barnhart-Morrow Consolidated, filed his petition for approval to pay receiver's expenses with the Court in said cause of action No. 325061. Said petition is Exhibit No. 52.

#### XL.

That pursuant to hearing had, the Court issued its order approving account and report of Ralph S. Armour, receiver, (Exhibit 52-A).

#### XLI.

Barnhart-Morrow Consolidated did file capital stock tax returns for the fiscal years ending June 30, 1933, and June 30, 1934, and in each of said returns claimed exemption from any liability for capital stock taxes for the years ending on said dates on the basis that the said company was inactive, not doing business and in the hands of a receiver. The exemption claimed by said Barnhart-Morrow Con-

solidated in capital stock tax returns filed by it for the years 1933 and 1934 was sustained by the Commissioner of Internal Revenue, in accordance with letter received [79] from said Commissioner of Internal Revenue under date of January 30, 1936, copy of which letter is attached hereto, marked Exhibit No. 53.

Barnhart-Morrow Consolidated did not file capital stock tax returns for the fiscal years ending June 30, 1935 and June 30, 1936, but did file a capital stock tax return for the fiscal year ending June 30, 1937 on September 29, 1937, pursuant to extension granted to that date in which to file such return, with an Original Declared Value of Entire Capital Stock of \$800,000.00 and paid the tax shown due thereon of \$800.00.

## XLII.

On July 29, 1931, at which time Ralph S. Armour was appointed receiver for Barnhart-Morrow Consolidated, there had been accrued on said corporation's books and records as "accrued payroll" payable to Guy L. Hardison the sum of \$14,000.00. The said amount was accrued at the rate of \$1,000.00 per month to July 31, 1931.

There was also recorded on the Company's records and shown as due to Mr. Hardison on July 31, 1931, the sum of \$8,500.00 representing two notes payable, dated July 30, 1930, due one year after date; one note being issued for \$4,000.00 and a second note for \$4,500.00. That said amount of \$8,500.00 so set up as a liability to Mr. Hardison on the Company's records arose out of a purported transaction relative

to Mr. Hardison selling to the company a [80] certain oil well derrick and equipment pertaining to Well No. 17.

The salary accrued to Guy L. Hardison in the amount of \$14,000.00 and the \$8,500.00 notes as set forth above, both of which items were in dispute, was not settled until December 11, 1936, on which date the board of directors authorized the payment of \$7,000.00 for salary to Mr. Hardison, which amount paid his salary accrued on the company's records to December 30, 1930 (Exhibit No. 54). The balance of the salary of Mr. Hardison which was accrued on the company's records from January 1, 1931 to July 31, 1931, at \$1,000.00 per month, during which time a receiver was appointed in the matter of Julian v. Schwartz and the oil properties operated by such receiver, was not recognized or paid (Exhibit No. 54).

### XLIII.

That pursuant to a resolution of the board of directors, dated March 5, 1937, a copy of which is attached hereto as Exhibit No. 55, Barnhart-Morrow Consolidated paid a dividend in the amount of \$6,949.77 on April 5, 1937.

### XLIV.

In December 1936 and in April 1937 Barnhart-Morrow Consolidated acquired by purchase certain "Regular and Special" Participating Oil Agreement interests in Julian Wells Nos. 1, 2 and 3, on account of which Barnhart-Morrow Consolidated

was paid the amount of \$14,026.50 in 1937, [81] which amount for the year 1937 constitutes dividends received.

Dated this 3rd day of October, 1941.

J. P. WENCHEL,

[Illegible initials.]

Chief Counsel Bureau of Internal Revenue.

HAROLD C. MORTON,

B. W. BURKHEAD,

Counsel for Petitioner.

[Endorsed]: U.S.B.T.A. Filed Oct. 4, 1941. [82]

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[Title of Board and Cause.] [83]

United States Post Office and Court House,

Los Angeles, California,

October 4, 1941. 9:35 o'clock a. m.

Before:

Hon. Richard L. Disney

Met pursuant to notice.

Appearances:

B. W. BURKHEAD and

HAROLD C. MORTON,

1126 Pacific Mutual Building,

Los Angeles, California,

Appearing for Barnhart-Morrow Consolidated, the Petitioner.

E. A. TONJES,

Appearing for the Commissioner or Internal Revenue, Respondent. [84]

## PROCEEDINGS

The Clerk: 105859, Barnhart-Morrow Consolidated.

The Member: State the appearances and case for the petitioner.

The Clerk: B. W. Burkhead of 1126 Pacific Mutual Building, Los Angeles, for the petitioner; Mr. E. A. Tonjes for the respondent.

Mr. Burkhead: Mr. Harold C. Morton, 1126 Pacific Mutual Building, also for the petitioner. He appears on record for the petitioner.

Mr. Morton: Your Honor will recall ten days ago on this matter the Julian Syndicates were first called on this calendar and I made a descriptive statement and suggested that in the interests of time and a better understanding of the matter and a better presentation, an attempt would be made to stipulate to the facts in both those cases, that is, the syndicate cases and this case. The syndicate cases have been disposed of by a stipulation covering the entire matter.

In the Barnhart-Morrow matter, the case before your Honor, a stipulation has been entered into between counsel for the parties, some 35 pages in writing, which identify 54 documents to be marked as exhibits, and at this time I can present to the Clerk the original of that stipulation, together with the documents which are referred to and which the Clerk will find have been marked with the appropriate [86] exhibit numbers so he will have no trouble giving his appropriate designations to them. They bear the same numbers.

The Member: These documents, I take it, all come in without objection?

Mr. Morton: That is right. They all have been stipulated to and have been covered fully and come in without objection.

The Member: They are not attached?

Mr. Morton: Physically they could not be attached. As a matter of fact, the stipulation will in some instances refer to the fact that the exhibit is attached. As a matter of fact, it is not physically attached, so the record will be clear on that.

The Member: Well, let the stipulation be filed and the facts therein set forth; and the exhibits numbering from 1 to 55 inclusive are on the part of the petitioner, are they, or are they joint exhibits? You have stipulated those facts. I suppose they should be joint exhibits.

Mr. Morton: We will offer them. They may be deemed our exhibits or joint. It doesn't matter. Both parties of necessity have to have them.

The Member: It is simpler to call them petitioner's exhibits, and under the circumstances we will do that.

Petitioner's Exhibits 1 to 55 inclusive are admitted in evidence. [87]

(The said exhibits, so offered and received in evidence, were marked Petitioner's Exhibits 1 to 55, and made a part of this record.)

## PETITIONER'S EXHIBIT No. 41

(Copy)

(Excerpts From Exhibit 41)

Cross-Complaint of L. V. Redfield, F. E. Foster and H. A. Penn (on behalf of Holders of Participating Oil Agreements) in the Case of Julian vs. Schwartz, No. 315345.

Come now L. V. Redfield, F. E. Foster and H. A. Penn, and file this their cross-complaint herein. For convenience in this cross-complaint, the cross-complaints will be referred to as "complaints" and the cross-defendants will be referred to as "defendants".

On behalf of themselves and all other holders of "Well No. One Participating Oil Agreements", "Well No. Two Participating Oil Agreements", "Well No. Three Participating Oil Agreements" and "Wells No. 11 and 12 Participating Oil Agreements" hereinafter referred to, who may join as complainants herein, these complainants allege:

\* \* \* \* \*

## IX.

Said C. C. Julian and his wife, Mary Julian, also to wit: on June 17, 1922, transferred and assigned said First Globe Lease and all their interest in said Brunson Lease to said Citizens Bank insofar as the same covered or affected the north 209 feet of the east 209 feet of the westerly 543 feet of the land described in said First Globe Lease to said C. C.

Julian, in trust and as trustee to hold the same for twenty-five years for the use and benefit of the assigns of said C. C. Julian of the petroleum produced from said premises and set aside said premises as an exclusive drilling site of an oil well thereon to be known as Well No. Two; that said assignment was accepted by said Citizens Bank as trustee and was recorded on October 5, 1922 in book 1382, page 347 of official records of Los Angeles county in the office of the county recorder thereof. A true copy thereof is hereto attached, marked "Exhibit E" and made a part of this cross-complaint.

Under said assignment and as trustee of said premises, the said Citizens Bank on or about June 17, 1922 made its declaration of trust which was substantially the same in form and effect as the declaration of trust covering the property assigned and set aside as the drilling site for Well No. One except that it set forth the property described in Well No. Two assignment.

Thereafter defendant Julian, in consideration of moneys furnished him for drilling an oil well on said drilling site or premises known as Well No. Two, sold and assigned to purchasers thereof undivided interests in the net production of oil from said oil well on said premises and the net proceeds of the sale of oil produced in said premises, and made and entered into agreements with each and all of the purchasers of said participating interests identical with the agreements made by the defend-

ant Julian with purchasers of participating interests in Well No. One. Said participating agreements are referred to as "Well No. Two Participating Oil Agreements."

Said participating interests and agreements on the part of defendant Julian were made assignable and the complainants herein are now the owners and holders of a large number thereof, the total holdings of these complainants of such participating units now representing the right to more than twenty per cent (20%) of the net production of petroleum from said premises designated as Well No. Two.

Said "Well No. Two Participating Oil Agreements" were acknowledged so as to entitle the same to recordation and at least one was recorded prior to January 1, 1924 in the office of the county recorder of Los Angeles county to wit: on September 28, 1922, in book 1221 at page 186 of official records.

With moneys so furnished by the purchasers of said "Well No. Two Participating Oil Agreements", defendant Julian drilled an oil well on said Well No. Two drilling site, which is known as Well No. Two and oil has been produced from said Well No. Two since November, 1922 and is now being produced from said well.

\* \* \* \* \*

## XVII.

Defendants Julian, Beyer and Roth have defaulted in the performance of the covenants contained in their said participating agreements with

the purchasers of interests in said "Second Globe Lease" and in the production from said wells No. 11 and No. 12, in that said defendants discontinued the operation thereof; that contrary to their said agreements with the purchasers of interest in said oil wells Nos. 11 and 12, said Julian, Beyer and Roth on or about January 15, 1925, delivered the possession and operation of said oil wells over to the defendants D. R. Morrow and W. J. Barnhart and entered into a written agreement with said D. R. Morrow and W. J. Barnhart purporting to give to said defendants Morrow and Barnhart the full right and power to operate said oil wells and to have and receive 50% of the gross production of said wells, without any deduction therefrom for the costs and expenses of operating said wells, all without the consent of these complainants or other owners of interest in said oil wells; that in violation of their said agreements defendants Julian, Beyer and Roth authorized and permitted said D. R. Morrow and W. J. Barnhart, and the defendant Barnhart-Morrow, Inc., and Barnhart-Morrow Consolidated, as successors and assigns of said D. R. Morrow and W. J. Barnhart to continue in the possession and operation of said oil wells Nos. 11 and 12, and to receive and dispose of the production thereof and to have and receive a large portion of the proceeds from the production of said wells to which the holders of said participating interests are entitled;

That said oil wells Nos. 11 and 12 have not been

operated in the manner provided for in said agreements by said lessees; that the oil produced therefrom has not been marketed in the manner provided for in said agreements; that the proceeds from the sale of oil have not been disposed of as provided for in said agreements; that the costs, charges and expenses incurred in the operation, maintenance and management of said well have not been paid upon presentation by said lessees or their nominees of proper bills and statements therefor accompanied by the affidavits of said lessees or their nominees that said charges, costs and expenes were necessarily and properly incurred in connection with said operation, maintenance and management of said wells; and all of the proceeds from the sale of the production of said wells have not been paid to said Citizens Bank and distributed by said bank in the manner provided for in said agreements.

And on information and belief, these complainants allege that the abandonment of the operation of said wells Nos. 11 and 12 by defendants Julian, Beyer and Roth, and the delivery by them of the possession thereof to said Morrow and Barnhart and their successors and their agreements with said Morrow and Barnhart and their successors in connection with the operation of said oil wells were all for the purpose and to the end that said C. C. Julian should receive secret profits and moneys to which the holders of said participating interests were and are entitled from the proceeds of the production of oil from said oil wells.

\* \* \* \* \*

## XX.

Complainants allege and claim that all oil produced from trespassing Well No. 14 and the proceeds thereof belong to the holders of participating interests in said oil well No. 1; that all oil produced from said trespassing Well No. 16 and the proceeds thereof belong to the holders of participating interests in said oil well No. 2; that all oil produced from said trespassing Wells No. 15 and No. 17 and the proceeds thereof belong to the holders of participating interests in said oil well No. 3; that all oil produced from said trespassing Italo Wells Nos. 1, 2 and 3 and the proceeds thereof belong to the holders of participating interests in said oil wells Nos. 11 and 12. Complainants are entitled to an accounting from the defendants W. J. Barnhart, D. R. Morrow, C. C. Julian, Santa Fe Springs Oil Company, Italo Petroleum Corporation and their successors and from the receiver appointed in this action and from all other persons who have received or hold oil or the proceeds from the sale of oil from any of said wells Nos. 14, 15, 16 and 17 or from said Italo Wells Nos. 1, 2 and 3, and to have the amount due them as proceeds from the sale of oil produced from said trespassing wells ascertained and determined.

\* \* \* \* \*

Wherefore, complainants, pray for orders, decrees and judgments of this court as follows:

\* \* \* \* \*

3. That it be adjudged and decreed that said "United Lease" to defendant W. J. Barnhart conveyed no right, title or interest in any of the premises embraced and described in said first and second Globe leases or in either of them; that said "United Lease" was made in violation of said first and second Globe leases and is void; that all acts of said defendant W. J. Barnhart and/or of his assigns in entering upon any of the premises described in said first and second Globe leases or either of them under said United Lease and the drilling and operating of said Wells Nos. 14, 15, 16 and 17 and said Italo Wells Nos. 1, 2 and 3, and producing oil therefrom are trespasses upon the rights and interests of these complainants and others holding as assignees of C. C. Julian under said first and second Globe leases.

\* \* \* \* \*

7. That defendant C. C. Julian be removed as agent for complainants and other holders of participating interests in said Wells 1, 2 and 3, either in the operation of said oil wells or in the disposition of the production or proceeds from the sale of the production thereof and from any office or position of trust in connection therewith and that the possession of said oil wells and the premises embraced in their drilling sites and the right to operate the oil wells drilled thereon for the benefit of those entitled to the production thereof to be given the owners of the participating interests in each of said wells Nos. 1, 2 and 3 or to such com-

petent person or persons as the holders of said participating interests may designate as their agency for that purpose.

8. That defendants Julian, Beyer and Roth be removed as agent for complainants and other holders of participating interests in said Wells 11 and 12, either in the operation of said oil wells or in the disposition of the production or proceeds from the sale of the production thereof and from any office or position of trust in connection therewith and that the possession of said oil wells and the premises embraced in their drilling sites and the right to operate the oil wells drilled thereon for the benefit of those entitled to the production thereof be given the owners of the participating interests in said Wells 11 and 12, or to such competent person or persons as the holders of said participating interests may designate as their agency for that purpose.

9. That defendants C. C. Julian, W. J. Barnhart, D. R. Morrow, Barnhart-Morrow Consolidated Barnhart & Morrow Inc., United Oil Well Supply Company, Wm. B. Himrod, W. W. Hyams, Citizens National Trust and Savings Bank, Syndicates Distributors Inc., Sunset Pacific Oil Company, Hercules Gasoline Company, Italo Petroleum Corporation, Santa Fe Springs Oil Company, El Camino Oil Corporation, and defendants Richard Roe One to Fifty inclusive and defendants Richard Roe Corporations One to Five inclusive, and each

of them, be ordered to account for all oil and all proceeds from the sale of oil produced from any of the oil wells on the land embraced and described in said first and second Globe leases, or either of them, and that upon such accounting the amount of such oil and/or proceeds thereof to which each of these complainants and others holding similar participating interests under said Wells Nos. 1, 2 and 3 and 11 and 12 participating oil agreements who may join as complainants herein are entitled shall be determined and each of such complainants herein shall be given separate judgments against each of said defendants for the amount so found to be due each such complainant from each such defendant.

OLSON AND OLSON  
By CULBERT L. OLSON

Attorneys for Cross-Complainants.

[Endorsed]: U.S.B.T.A. Filed Oct. 4, 1941.

## PETITIONER'S EXHIBIT No. 47

Minutes of a Meeting of the Board of Directors of Barnhart-Morrow Consolidated Held December 17, 1937

A meeting of the Board of Directors of Barnhart-Morrow Consolidated was held at the office of the corporation, 1009 Title Guarantee Bldg., Los Angeles, California, on December 17, 1937 at four o'clock P.M.

All directors were present.

The minutes of the previous Director's Meeting held October 8, 1937 were read and approved.

Mr. Stabler reported that the joint venture well in the Tejon area tested 1400# pressure and it had been decided to kill same and drill for possible deeper oil sand. Discussion was held relative to the drilling of another well as a joint venture with the same companies in the Tejon area if the present well being drilled proves to be a commercial well. It was moved by Mr. Stabler, seconded by Mr. Brandt and carried, that Barnhart-Morrow Consolidated join with Universal Consolidated and Wilshire Oil Company in the drilling of a second well in the Tejon area providing the present well proves a success and if the other companies so decide.

It was moved by Mr. Morton, seconded by Mr. Brandt, Mr. Smith not voting, that the following resolution be adopted:

Whereas in view of the small production and interest in Well #16 at Santa Fe Springs, it is deemed not profitable to operate this well, and

Whereas J. A. Smith is the owner of a paramount title to the lease on which this well is located, and is willing to accept a quitclaim deed to this well:

Resolved: that Barnhart-Morrow Consolidated release, surrender and quitclaim unto J. A. Smith the following

That certain oil well in the Santa Fe Springs Oil Field commonly known as Julian Well No. Sixteen (16), together with the premises pertaining thereto, described as that portion of the West Five Hundred Forty-three (543) feet of the North half of the North half of the Northeast quarter of the Southwest quarter of Section 6, Township 3 South, Range 11 West, S.B.B.&M., Los Angeles County, California, commencing at a point in the northerly line thereof Five Hundred Forty-three (543) feet distant from the Northwest corner of said property; thence South One Hundred Fifty (150) feet on a line parallel with the Westerly boundary line of said property to a point; thence West Two Hundred (200) feet and parallel with the Southerly line of said property to a point; thence North One Hundred Fifty (150) feet on a line parallel with the Westerly boundary line of said property to a point on the Northerly boundary line of said property, thence East Two Hundred (200) feet along the northerly boundary line of said property to the place of beginning, containing Fifty-seven One Hundredths (57/100ths) of an acre, more or less;

Mr. Smith discussed with the Board the matter of a nominal expense account, advising that he personally paid his traveling, automobile and telephone expense expended on behalf of the company. It was moved by Mr. Stabler, seconded by Mr. Brandt, and carried (Mr. Smith not voting) that Mr. Smith be allowed \$200.00 per month to cover expenditures made by him on behalf of this corporation, same being retroactive to December 15, 1936.

Mr. Stabler advised the Board that the corporation had made a loan of \$1500.00 to 99 Oil Company, evidenced by their ninety day note for \$1500.00 dated December 16, 1937, bearing interest at the rate of 7%.

Mr. Smith submitted an offer to the Board for the purchase from one L. V. Redfield of approximately twelve hundred (1200) units in the Julian #11 Well. It was moved by Mr. Stabler, seconded by Mr. Brandt, and carried that no units in Julian Well #11 be purchased by reason of the fact the Board considers them of no value.

The meeting then adjourned.

H. C. HORSNELL  
Secretary

[Endohsed]: U.S.B.T.A. Filed Oct. 4, 1941.

**YEARS  
ERSHIP**

Dec. 31,  
1933

Dec. 31,  
1934

Dec. 31,  
1935

## PETITIONER'S EXHIBIT No. 51

## BARNHART-MORROW CONSOLIDATED

COMPARATIVE BALANCE SHEET AS AT THE CLOSE AND FOR THE YEARS  
SHOWN AND DURING WHICH TIME THE COMPANY WAS IN RECEIVERSHIP

	ASSETS			
Details	Dec. 31, 1930	Dec. 31, 1931	Dec. 31, 1932	Dec. 31, 1933
				Dec. 31, 1934
Cash and Receivables				
Cash	\$ 3,361.36			
Notes Receivable	350.00	\$ 3,395.61		
Accounts Receivable	8,140.90	115.79		
Total Cash and Receivables	11,852.26	3,511.40		
Inventories				
Supplies	594.09	\$ 594.09	\$ 594.09	\$ 594.09
Deferred Charges	1,187.05			
Prepaid Insurance				
Other	55.79			
Total	1,242.84			
Capital Assets				
Leasehold Interests				
Santa Fe Springs—Wells 1, 2, 3 and 11	224,251.92	224,251.92	224,251.92	224,251.92
Long Beach—Hartley Well	7,500.00			
Oil Well Machinery and Equipment				
Santa Fe Springs—Wells 1, 2, 3, 11, 16 and 17	67,658.89	66,943.96	66,943.96	66,943.96
Long Beach—Hartley Well	10,556.45			
Intangible Oil Well Costs				
Santa Fe Springs—Well 16	60,907.12	60,908.31	60,908.31	60,908.31
Long Beach—Hartley Well	54,722.57			
Automobiles and Trucks				
Santa Fe Springs	7,334.65	7,289.65	7,289.65	7,289.65
Office Furniture and Fixtures				
Total	482,931.60	359,393.84	360,205.34	360,205.34
Less—Reserve for Depreciation and Depletion	78,368.96	90,293.46	95,845.91	106,520.86
Net Amount Capital Assets	354,562.64	269,110.38	264,359.43	258,546.84
Patents	1,000.00	1,000.00	1,000.00	1,000.00
Goodwill	26,224.21	26,224.21	26,224.21	26,224.21
Other Assets				
Capital Stock issued for Services & Leases	219,120.50	219,120.50	219,120.50	219,120.50
Organization Expense	42,488.53	42,488.53	42,488.53	42,488.53
Hartley Well No. 1—Salvage	50.00	50.00		
Total	26,609.03	261,659.03	261,609.03	261,609.03
Accounts Receivable—Collection and realization on which will exceed one year				
C. C. Julian	7,104.61	7,104.61	7,104.61	7,104.61
W. J. Barnhart and/or East Santa Fe Springs Escrow Account	17,363.15	20,478.25	24,673.29	21,978.00
Sundry Accounts	25.00	296.31	296.31	296.31
Texas Co.—Gas Revenues Withheld				
J. A. Smith—Contra against indebtedness due him				
Total	24,492.76	27,879.17	36,267.68	32,334.82
Grand Total	\$681,577.83	\$589,978.28	\$590,104.44	\$577,323.38

Geo. F. Meitner & Co., Auditors and Accountants

Exhibit No. 51 Part One

## Petitioner's Exhibit No. 51—(Continued)

## BARNHART-MORROW CONSOLIDATED

COMPARATIVE BALANCE SHEET AS AT THE CLOSE AND FOR THE YEARS  
SHOWN AND DURING WHICH TIME THE COMPANY WAS IN RECEIVERSHIP

## LIABILITIES

Details	Dec. 31, 1930	Dec. 31, 1931	Dec. 31, 1932	Dec. 31, 1933	Dec. 31, 1934	Dec. 31, 1935
Notes Payable .....	\$ 15,134.15	\$ 4,916.18	\$ 4,137.50	\$ 3,320.70	\$ 3,000.00	\$ 3,000.00
Accounts Payable .....	19,628.34	21,597.37	22,316.68	17,778.11	17,160.43	17,267.70
 Accrued Expenses						
Interest .....	282.14	196.67	196.67	796.67	1,096.67	1,396.67
Taxes .....	40.83	820.51	586.64	611.64	780.41	1,051.66
Pay Roll .....	14,931.15	21,078.00	21,078.00	14,078.00	14,078.00	14,078.00
Due to Stockholders .....	7,070.63	6,995.63	6,995.63	6,995.63	6,995.63	6,995.63
 Total Liabilities .....	<u>57,087.24</u>	<u>55,604.36</u>	<u>55,611.12</u>	<u>43,580.75</u>	<u>43,111.14</u>	<u>43,789.66</u>
 Deferred Credits .....						
Capital Stock .....	694,977.00	694,977.00	694,977.00	694,977.00	694,977.00	694,977.00
Surplus—being a deficit .....	70,486.41	160,603.08	165,*16.93	163,582.01	166,098.01	172,161.65
 Grand Total .....	<u>\$681,577.83</u>	<u>\$589,978.28</u>	<u>\$590,*04.44</u>	<u>\$580,308.99</u>	<u>\$577,323.38</u>	<u>\$571,938.26</u>

\* Illegible figures.

Exhibit No. 51 Part Two

Geo. F. Meitner &amp; Co., Auditors and Accountants

[Endorsed]: U.S.B.T.A. Filed Oct. 4, 1941.



The Clerk: Mr. Burkhead, do you have a copy of the stipulation of facts?

Mr. Burkhead: Four extra copies in that folder.

The Member: State the case, one of you. What is it about?

Mr. Morton: Inasmuch as I have to be a witness, certain items it might be more proper if Mr. Burkhead would more briefly sketch it. I sketched it the other day without stopping to think about that.

#### Statement of Case on Behalf of Petitioner

Mr. Burkhead: If your Honor please, there are five issues involved in the matter, the first being a salary item which was accrued on the books to a Mr. Hardison for the salary for the year 1931, from January 1st to July 1st of 1931. The salary items accrued in the amount of \$14,000.

In the year 1936 a settlement was reached whereby Mr. Hardison was paid \$7,000, and \$7,000 was written off the books of the corporation and charged to profit and loss. That \$7,000 item is in issue as to whether or not the \$7,000 that was written off was income of Barnhart-Morrow for the year 1936.

The second issue covers a matter of \$16,500.10 which arose in this way: A Mr. Flesher claimed an interest in the [88] proceeds of one of these oil wells involved. Mr. Julian gave Barnhart-Morrow a letter indemnifying Barnhart-Morrow if they paid Mr. Flesher the \$16,500, and it later developed that he was not entitled to the receipt of the money. After the judgment of the court in the case of Julian v. Schwartz it was determined that Mr.

Smith was entitled to that \$16,500. After that judgment became final and in the year 1936 Barnhart-Morrow paid the \$16,000 to Mr. J. A. Smith. We shall offer evidence to the effect that it was not possible for Barnhart-Morrow to recover the \$16,500 already paid to Mr. Flesher. They wrote that off as a bad debt or a business loss in the year 1936.

The third question involved—

The Member (Interrupting): You said paid Mr. Flesher. I thought you said he wasn't entitled to it and they paid it to Smith.

Mr. Burkhead: They had previously paid it to Mr. Flesher in the year 1930 and at that time took a letter of indemnification from C. C. Julian and later had to pay the same amount to Mr. Smith.

The third issue is with reference to the abandonment of Well No. 16. It developed in the year 1937 that that well was costing Barnhart-Morrow more money to operate than they were receiving from it by reason of the fact that Barnhart-Morrow's interest arose out of an operating agreement whereby [89] they operated the well and paid all of the expenses of operating for 50 per cent of the proceeds. Mr. J. A. Smith, the same person to whom the \$16,500 was paid, owned the other 50 per cent of the proceeds from Well No. 16. His share of the operating expense by the terms of that operating agreement under which Barnhart-Morrow produced the well was limited to, I believe, \$250 per month. Since Barnhart-Morrow had to pay Mr. Smith 50 per cent of the proceeds of the well, it was costing them a certain amount to operate the well, they

were losing money, so Well No. 16 was abandoned to Mr. Smith who held the prior leasehold interest.

When Barnhart-Morrow abandoned the well, it reverted to Mr. Smith. That is the fourth question involved, as to whether or not the Barnhart-Morrow Consolidated is entitled to the deduction or that loss from the abandoned Well No. 16

The fifth question is whether or not during the year 1936 during which year up until I believe November 14th of the year 1936, Barnhart-Morrow's assets were in the hands of the receivers and co-trustees under the Julian v. Schwartz litigation. The question involved there is whether or not during that period of time Barnhart-Morrow was insolvent, and there is no question but what they were in the hands of the receiver, but the question is whether or not they were insolvent. [90]

I must have skipped a number, because there are only five issues involved here and I have spoken of five. I don't remember which one I missed

Mr. Tonjes: Depletion.

Mr. Burkhead: That is the question of depletion. That arises in this way, as to whether or not Barnhart-Morrow is entitled to figure depletion upon the amount, the total amount, of oil, and the proceeds received from oil, by the co-trustees while they were operating the properties, or whether or not their depletion is to be based upon the actual amount of cash that the trustees handed over to Barnhart-Morrow in 1936 after the co-trustees had paid all of the operating expenses of the well.

Barnhart-Morrow held an operating agreement

to operate the wells for which they were to pay the expenses of operating the wells and were to get 65 per cent of 70 per cent of the proceeds. That was determined in the judgment of Julian v. Schwartz. When it became final after the expenses of operating the wells had been deducted and the co-trustees paid to Barnhart-Morrow their share of what was left, 65 per cent of 70 per cent, and that depletion question resolved around on which figure we were to take to base depletion.

The Member: Do you have a statement for the respondent?

Mr. Tonjes: There are other issues set forth in the petition, your Honor, and I presume that those are waived. [91]

Mr. Burkhead: That is correct.

#### Statement of Case on Behalf of Respondent

Mr. Tonjes: That leaves five issues as stated by the counsel for petitioner.

I might say briefly what my position is with respect to these several issues.

The Member: First, before you start, you speak about others being waived. I was wondering about that, because there are a large number enumerated here. Are they waived or have some of them been disposed of by your stipulation?

Mr. Burkhead: No. They have been waived. They are small items.

The Member: All right. Go ahead.

Mr. Tonjes: With respect to the first item mentioned by counsel for the petitioner, the claim by the respondent that taxpayer realized \$97,000, that

is based on the fact that the obligation to pay the salary of \$14,000 was cancelled to the extent of \$7,000 and therefore the taxpayer realized taxable income for that extent, it being a solvent corporation at the time.

The second relates to a bad debt or loss claimed by the petitioner. I don't know whether it makes any difference particularly whether he claims it as a bad debt or a loss, although perhaps he should be called upon now to state which position he has taken. The amount is disallowed by the respondent as a deduction for the reason that—well, to state it generally, I guess the respondent questions the good faith of the transaction. Mr. Smith was an officer of the corporation, as I understand it, a majority or principal stockholder, and the entire circumstances surrounding the transaction do not constitute such facts which amount to an allowable deduction.

Now, with respect to the depletion item, which is perhaps one of the more important questions of the case, respondent's position there is that when the distributions were made in the years 1936 and 1937 from the trustees to Barnhart-Morrow, the petitioner, upon the termination of the litigation involving the various rates of the parties to the wells which the petitioner was operating, that is, he had an operating agreement, the respondent contends that when those payments were made, that they constitute the petitioner's gross and net income for the purpose of determining depletion; in other words, what the court ultimately ordered to

be paid to the petitioner was a specific amount in cash which was the result of several years', net result of several years' operations of the wells which were covered by the operating agreement; that petitioner never had any constructive possession of the gross income and that when he finally got something, it was net income, and the depletion allowance is limited to that. [93]

The Member: You contend that is what he would have got under Section 114 of the property?

Mr. Tonjes: Yes, your Honor.

Another issue is the abandonment of Well No. 16. That, of course, is perhaps largely factual. We have stipulated that the property was quitclaimed, but there again it was quitclaimed to a stockholder of the organization, Mr. Smith again, and apparently there was no effort made to salvage any property or anything of that sort. It was just given to him, and respondent submits that under the circumstances, why, there is no deductible loss resulting, and if there is a loss at all, it is a capital loss and the capital limitation applies.

The Member: It was claimed as an ordinary loss.

Mr. Tonjes: I think it was, yes, your Honor.

The remaining issue is the question of the solvency of the corporation, and I think that depends largely on whether or not the assets of the corporation, the properties which were used in connection with the operating of the wells, and the other assets which the petitioner ultimately received by reason of the court decision might be deemed to be such assets to take into consideration in determining the

corporation's net worth, that is to say, whether its assets exceeded its liabilities or not. That is, I should say, also rather factual.

The Member: Now, in addition to the evidence already [94] adduced in the form of a stipulation and 55 exhibits, put on the rest of your evidence as to the petitioner.

Let the record show that it is agreed there is no Exhibit No. 13 among the 55 exhibits attached to the stipulation.

Mr. Burkhead: That is correct.

Mr. Tonjes: I don't have any 13. I haven't noticed it before, your Honor.

The Clerk: I checked the stipulation.

The Member: Let the record so show it is agreed. Put on your evidence.

Mr. Burkhead: Mr. Morton.

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### HAROLD C. MORTON

a witness on behalf of petitioner, was duly sworn and testified as follows:

The Clerk: You will tell the reporter your name, please, Mr. Witness.

The Witness: Harold C. Morton. M-o-r-t-o-n.

The Member: You are taking the stand. Mr. Morton, as an attorney to do some identification?

The Witness: No, your Honor. I was in the position of being a director and participant in some of the proceedings involved here, and in fact it will appear that I made a motion with respect to

(Testimony of Harold C. Morton.)

one of the resolutions involved; hence, of necessity, I have to appear as a witness. That is the reason that any argument I would not personally participate [95] in.

The Member: Go ahead under the circumstances.

Direct Examination

Q. (By Mr. Burkhead) Mr. Morton, were you connected with Barnhart-Morrow Consolidated during the year 1936?

A. Yes, sir. I was their counsel, one of their counsel in the year 1936, and at that time a stockholder; that is, the law firm of which I am a member, Byron Hanna and Harold Morton, was a stockholder in the company. My recollection is I was not a director until some time early in 1937. I am a director at the present time.

Q. During the year 1936 did the question of salary owing to a Mr. Hardison, was that discussed by the board or directors in your presence?

A. It was, and I was called upon to negotiate with Mr. Hardison, who was president of the company, in an endeavor to adjust the matter, and did participate in that regard. His salary was a matter which was in dispute, that is, this salary which has been referred to in these proceedings, or, rather, that is referred to in these proceedings.

The Member: That is the \$7,000 item?

The Witness: Yes. It was a larger amount, but it was settled at the \$7,000 figure.

Q. (By Mr. Burkhead) Did you negotiate with

(Testimony of Harold C. Morton.)

Mr. Hardison with reference to a settlement of that claim? [96]

A. I did, and reported to the board my negotiations and the result of them, and the board by a resolution approved the payment of \$7,000 and no more on Mr. Hardison's claim. That occurred, the action of the board occurred, on the 11th of December, 1936.

Q. A copy of that resolution passed by the board of directors has been introduced as an exhibit, if the Court please, and attached to the stipulation.

A. I so understand it. That is the reason I didn't refer to the matter further.

Mr. Burkhead: May I speak to the witness off the record?

The Member: Yes.

(Conference between counsel and the witness.)

Mr. Burkhead: I suggest, if your Honor please, that as we go along with these different items that we complete the record as to each issue involved and then go to the next one, so if counsel wishes to cross examine the witness on this particular point, he can do that.

The Member: Well, that would of course make it rather well cut and definite, but I would think that your cross examination in that way would be rather confusing as a whole. I suggest that you just pass from one issue to the other and opposing counsel may in the same way follow the different issues in this examination.

(Testimony of Harold C. Morton.)

Q. (By Mr. Burkhead) During the year 1936 did the matter [97] of the payment of \$16,500.10 to Mr. J. A. Smith, which amount had theretofore been paid to one Flesher after the receipt of an indemnity letter from C. C. Julian, was that matter presented to the board and discussed by the board of directors?

A. It was, and in my presence. That indemnity agreement, for the sake of the record, is marked Exhibit 39, and pursuant to that indemnity agreement the stipulation shows that there have been paid to Flesher, a transferror of C. C. Julian, an interest in the Well No. 16 in the sum of \$16,500.10, that transfer being made in spite of the matter set forth in Exhibit 38 which was a communication showing that someone else at that time—by "that time" I mean in 1929 or '30—when the money was started to be paid by Flesher, it was claimed by somebody else. The record shows that in the case of Julian v. Schwartz the court's final determination was that J. A. Smith owned that interest as successor to the people that had claimed it at the time payment start to Flesher, and Smith then presented—

Mr. Tonjes (Interrupting): I will suggest that the witness refrain from arguing the case. It is a little beyond the scope of the question.

The Witness: I will try to. I am sorry.

Q. (By Mr. Burkhead) The record shows that by stipulation and the copy of the judgment in Julian v. Schwartz which [98] is attached to it as

(Testimony of Harold C. Morton.)

an exhibit J. A. Smith was entitled to receive the proceeds from the interest of which that \$16,500.10 had been paid.

Did you have any discretion in your capacity as attorney for Barnhart-Morrow with the board of directors as to whether or not Barnhart-Morrow Consolidated would again have to pay that \$16,500 and would have to pay it to Mr. Smith?

A. Well, the matter was discussed with the board of directors at a meeting held on November 20, 1936, at which time Mr. Smith had presented a statement and a claim for that amount. At that time I reviewed the entire situation with the members of the board of directors and advised them in my opinion of the situation, which was that Mr. Smith was entitled to the funds and they should not have been paid out in any event the way they had been and the court had determined Smith was entitled to that interest and we had no recourse—by "we" I mean Barnhart-Morrow—other than to pay it, and the board on that date adopted a resolution approving the account of Smith, which included this \$16,000 item.

Q. In advising the board that that amount would have to be paid to Mr. Smith, did you also discuss with them the possibility of recovering the amount from either Mr. Julian or Mr. Flesher? [99]

A. Yes. The matter was discussed. As was known to all, Mr. Julian had committed suicide in China and Flesher, his nominee in the matter, knowing this situation was coming up, I had endeavored

(Testimony of Harold C. Morton.)

to locate with the possibility of recovery. Flesher to my own knowledge was one of Julian's associates and at the time Julian and a number of his associates were indicted in the state of Oklahoma Flesher had disappeared and we were unable to locate him or find any trace of him.

Q. Now, directing your attention to the year 1937 and about the month of December with reference to what was known as Well No. 16 in particular, will you state the interest that Barnhart-Morrow Consolidated had in that well and how that interest arose?

A. Well, the documents with respect to that are all marked and identified by the stipulation. If there is no objection to reciting that chain of title for the sake of clarity, I will do so, but I wouldn't want to if Mr. Tonjes at this time thought it might be unnecessary.

Mr. Tonjes: I don't think it is necessary. If you will just make reference to the document, that will be all right. The exhibit will show that, and I think it will be sufficient.

The Witness: Yes.

That well in question, No. 16, was one of a number of [100] wells located on this 10-acre Brunson property at Santa Fe Springs, and under a chain of title Barnhart-Morrow had drilled Well No. 16. The document which Mr. Burkhead just gave the member, 32 I believe—is that the document? Yes, it is. That provided that Barnhart-Morrow should drill the well and reimburse themselves for the cost at a certain amount and then one-half would belong

(Testimony of Harold C. Morton.)

to W. J. Barnhart, W. J. Barnhart in turn was holding that for Julian, and assigned it to a man by the name of Cady, the other half interest. And there is a chain of title here from Cady to Boyle and Cady and Boyle to Smith, being that same half interest which we were talking about a moment ago.

Barnhart-Morrow drilled the well and drew sufficient oil to reimburse their cost. The well had declined in production at the end of 1937 and certain questions arose with respect to it, but at that time the other half interest in the well was owned by J. A. Smith, and, as I believe I stated before, that had been the subject of the judgment in Julian v. Schwartz, which is marked in here as one of the exhibits.

Q. (By Mr. Burkhead) Now, during the year 1937 what was the condition of Well No. 16?

A. Well, at December 17, 1937, there was a directors meeting at which that matter was discussed and the fact was developed and pointed out—in fact, I brought the matter up—that we, that the Barnhart-Morrow Consolidated, were operating [101] this Well No. 16 at a loss. It was a small well. We had a half interest in the well only. Under the existing agreements which are marked here, the other half interest could be charged not to exceed \$250 a month for operating expenses. We had operated at a loss for something over a year and I recommended to the board at that time that we quitclaim that well to Smith, to him because he was the one next above us in the chain of title and to whom the title would be

(Testimony of Harold C. Morton.)

quitclaimed if we gave it up and abandoned it. Smith owned the other half. There was discussion on that, and on that date after that discussion there was a resolution adopted, Mr. Smith not voting, that covers the matter. And that resolution has been marked as an exhibit in this case.

The Member: Can you state the number?

The Witness: Yes, I am going to in just a second to make that clear.

The resolution, No. 47, and the quitclaim deed itself I note is marked Exhibit 46. The resolution so marked and which is an exhibit here commences with a recital that the well in question, identifying it, is deemed not profitable and that J. A. Smith is the owner of part title and would accept a quitclaim deed, and then the resolution proceeds to direct that it be quitclaimed.

I would like to explain that at this time, at the time of this quitclaim, I was personally very familiar with the [102] situation in the Santa Fe Springs oil field with respect to such old wells, being the fortunate or unfortunate owner of several such wells myself, and was familiar with the problems confronting such a well as this, and I advised the board at that time that I did not think the company should endeavor to put this well on greater production or to spend any money on it. I knew that Mr. J. A. Smith so advised the board, and so advised the board, had spent considerable money in an endeavor to return to production his well No. 14, which is another well located upon this same Brunson 10

(Testimony of Harold C. Morton.)

acres, and I knew he had spent a great deal of money running into some 60 or 70 thousand dollars endeavoring to return to production a well known at Italo No. 2 which was also located on this Bruns-  
son 10 acres.

Those matters were all discussed; that is part of the discussion which was referred to as having occurred in the minutes, which are Exhibit 47.

The Member: Is there any argument about the amount of the loss? I notice that \$43,000 plus is claimed. Is there any argument about the amount?

Mr. Tonjes: There is, your Honor. I don't concede the amount. As a matter of fact, I believe the petitioner claims there is a larger loss.

The Member: The petitioners claim \$143,151.96.

Mr. Tonjes: I think that might be correct. At least the [103] amount is larger than claimed in the original return. We do not concede the amount in any event.

The Witness: Those are figures which I as a witness can not throw light upon, that being a book-keeping matter.

Q. (By Mr. Burkhead) Mr. Morton, was there any change in the status of Barnhart-Morrow Consolidated between the date of January 1, 1936 and about November 14, 1936? A. Yes, there was.

Q. I am speaking from a financial standpoint.

A. Yes.

Q. Will you state the extent of that, as you recall it, if you have the figures?

A. Down to the finality of the judgment in

(Testimony of Harold C. Morton.)

Julian v. Schwartz, after which, and I believe some time in November, Barnhart-Morrow received some moneys which had been impounded in that litigation, Barnhart-Morrow was without funds to pay their obligations or to conduct their affairs.

Q. The change came about by reason of the receipt of the funds from the co-trustee?

A. Yes. After the judgment in Julian v. Schwartz became final, which I think was in the end of October or early November. It appears from the record, of '36.

Q. But prior to the receipt of the money from the co-trustees in November of 1936 and looking backward through the year 1936, the condition of the company from a financial standpoint [104] was about the same as it had been in the years '35 and '34?

Mr. Tonjes. That is objected to as calling for a conclusion, and not the best evidence. The books and records of the corporation are the best evidence.

Mr. Burkhead: That is all.

#### Cross Examination

Q. (By Mr. Tonjes) Mr. Morton, did you know whether or not there had been any resolution passed authorizing a fixed salary to Mr. Hardison at some prior date, that is, a date prior to the time that this compromise was effected?

Mr. Burkhead: I think we stipulated to that.

The Witness: Well, asking for my knowledge, I would say I would not know. The first time that I had any knowledge of Hardison's salary items

(Testimony of Harold C. Morton.)

were when they became involved in the suit of Morrow v. somebody, which is referred to in here, wherein the receiver was appointed for Barnhart-Morrow. In that litigation I know there were claims that there were excessive and fraudulent salaries. That was started in 1931, and included this Hardison salary; but whether that salary had been paid pursuant to a resolution, I cannot at this time recall, or, rather, had been set up pursuant to a resolution, because I understand it wasn't paid.

Q. They were accrued? A. Well—

Q. (Interrupting) On the books. We stipulated that, I be- [105] lieve.

A. If you did, I can't state because, of course, you understand I have never personally examined the books and records of Barnhart-Morrow other than the minute book since I have been interested in the company.

Q. You have no reason to believe, do you, that the salaries were not properly accrued?

A. If you ask my opinion, I am sure they were very improperly accrued. They were perfectly ridiculous and exorbitant salaries. In fact, Hardison conceded the same when I worked out the adjustment with him.

Q. You don't know the circumstances under which they were accrued?

A. Well, I know pretty well, Mr. Tonjes.

Q. Do you?

A. Yes, because it was a case of you pat me on the back and I'll pat you, between a man by the

(Testimony of Harold C. Morton.)

name of W. J. Barnhart and this man Hardison. One was president and the other general manager of the company.

Q. Were they the principal stockholders at that time?

A. They were the principal stockholders, but not majority stockholders.

Q. Not majority?

A. No. Barnhart-Morrow had hundreds of stockholders and their holdings together combined were a majority I am sure. [106] Oh, yes. I am certain of that, and Barnhart was general manager at a salary or purported salary of \$2,000 a month, having been appointed by Hardison after Hardison had been elected president with some such salary set up to him of a certain amount. That lead to the litigation in which a receiver was appointed for Barnhart-Morrow in 1931.

Q. Now, I believe you testified that the Barnhart-Morrow acquired its interest in the properties on which was located Well No. 16 by Mr. Smith?

A. No.

Q. What was the situation?

A. The way that was acquired, if I may state it to you, was with respect to Well 16, in 1928, after the deep sand had been discovered in the Santa Fe Springs oil field the holders of the land out there on this Brunson lease executed what is called the United Lease. That was executed to Barnhart, the same W. J. Barnhart. Barnhart then assigned all of the rights under that lease except with respect

(Testimony of Harold C. Morton.)

to a certain area which is described to Julian. Then on that executed area he made an operating agreement with Barnhart-Morrow that they would drill a well upon that particular area, which well became Well No. 16. His deal with Julian was on that particular area that Barnhart-Morrow would get to drill that well and a half interest after they got it across would belong to Julian, and, that is, the half interest then that Julian sold [107] to Cady and Cady to Boyle and Boyle to Smith and so on. That is the history of how Well 16 was drilled.

The operating agreement under which Barnhart-Morrow drilled that I think was identified a moment ago as Exhibit 32. The other documents which I have referred to in that chain of title, the United Lease, and so forth, are marked in this exhibit, but I don't have the numbers at my fingertips. But my reference with that claim will I think connect with the stipulation.

Q. I will just state that Exhibit 32 says under circumstances which require the operation of the well by natural flow the expenses shall be \$250 a month and when pumping \$500 a month. Does that refresh your recollection?

A. Yes, that is the agreement. Yes, sir.

Q. Now, when the well was quitclaimed, was it producing any oil at all?

A. Yes, it was producing, but not in sufficient amount that Barnhart-Morrow made a profit out of it. I think the records will show when they are presented here; it was my understanding at that

(Testimony of Harold C. Morton.)

time, certainly, and I acted upon that assumption that we were operating at a loss.

Q. You mean it would cost more than \$500 a month to operate the well and you would be reimbursed for no more than \$500?

A. We would only be reimbursed for \$250. We only had a half of it. We had a half of the lessee's interest. We oper- [108] ated the well and we could charge a total operating cost of \$500, which would mean against the other half \$250. And that was not sufficient to operate the well.

Q. Under the terms of the agreement, then, you were required to operate the well whether you made a profit or not, is that right?

A. That is right, as long as we held it. That is the reason we have it up.

Q. Well now, was there any equipment at this well?

A. Yes, there was equipment on the well, of course. There always is equipment on a producing oil well. That equipment presented some problems. In any event, the owner of the other half interest was entitled to half of it because Barnhart-Morrow in drilling the well had been reimbursed for their entitled cost, the entire cost on the premises. Whether Barnhart-Morrow could have insisted upon just stopping the well and saying "We will divide it up, divide up the physical equipment," was discussed at the board of directors.

I said I doubted whether we should do that, whether we should destroy something that might

(Testimony of Harold C. Morton.)

have some value to someone else, and in any event under the terms of the United Lease there were provisions giving the lessors the right when a lessee wanted to abandon to take possession of the entire thing, including the equipment, and under all the [109] circumstances we just decided to wash our hands of the entire matter and turn it over. That was the way the equipment was disposed of. What equipment was there is still on the premises, but we gave up all our right to the matter because there always is some salvage in an oil well, but under the circumstances here, why, we thought it was a matter of policy; at least I urged to the board to abandon the matter and forget about it and take the loss and have it over with.

Q. Have you any idea what the salvage would have been had you attempted to do so?

A. I haven't. It might have been as much as \$2,000.

Q. Now, when that property was quit claimed to Mr. Smith, was there any agreement on his part that he would continue to operate it?

A. No. We left that entirely to him. We had nothing to do with it and quitclaimed and left it. And I want to urge this in view of a question, if I may; I say "urge." A witness shouldn't say that, but I can't resist the expression. That matter was not suggested by Smith. I was the one that brought it up and suggested it to the board that we give up this well because I was rather closely in touch with the activities in Santa Fe Springs and know the

(Testimony of Harold C. Morton.)

situation here, that we were operating this well at a loss.

Q. And did Mr. Smith thereafter operate the well? [110]

A. I understand he did.

Q. And it was profitably operated, wasn't it?

A. He so informed me. He is here. You can question him about it.

Q. Well then, as a broad proposition you would say there were some profits flowing to the Barnhart-Morrow Consolidated by reason of this quit-claim of the well?

A. Well, in the sense we got rid of a property we were losing money on operating.

Q. And which you were bound to operate under the terms under which you held it?

A. As long as we held it, until such time as we quitclaimed it.

Q. Yes. And was Mr. Smith a stockholder at that time?

A. Mr. Smith was a stockholder at that time.

Q. Of Barnhart-Morrow?

A. Of Barnhart-Morrow, and a very substantial stockholder.

Q. Can you state the percentage of interest?

A. I can give it to you approximately. He can give you the exact figures, I believe. I believe Barnhart-Morrow had approximately 690,000 shares of stock outstanding. Smith stockholdings, his own interest in stockholders, was approximately 250,000 shares. I would like to state that I [111] believe

(Testimony of Harold C. Morton.)

Mr. Hanna's and my shares are some 63 or 64 thousand shares, and were at that time. There were a great many stockholders who held the balance of the stock.

Q. Did Mr. Smith partake in the discussion as to the advisability of the abandonment by the corporation?

A. No, he refrained from it. I asked him questions about what he had spent on his No. 14 well and on his Italo well which I knew he had worked unsuccessfully prior to this time.

Mr. Tonjes: I think that is all.

Mr. Burkhead: That is all.

The Witness: There has been no question asked, your Honor, but I would like to state that as far as I know, no other stockholder of Barnhart-Morrow has any interest of any kind in Smith's operations in that well after it was quitclaimed to him. I had none and Mr. Hanna had none and I know of no other stockholder having any interest.

(Witness excused.)

The Member: Call your next witness.

Mr. Burkhead: Mr. Smith.

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J. A. SMITH

a witness on behalf of petitioner, was duly sworn and testified as follows:

The Clerk: You will take the stand and give your name.

(Testimony of J. A. Smith.)

The Witness: J. A. Smith. [112]

Mr. Burkhead: If the Court please, we agreed to produce Mr. Smith for the benefit of Government counsel. He is the gentleman who has been waiting all week to get this matter through with and we would like to call him and let counsel examine him, if he wishes.

#### Direct Examination

Q. (By Mr. Tonjes) Mr. Smith, how many shares of stock did you own in Barnhart-Morrow Company late in the year 1936?

A. May I refresh my memory from a memorandum that I had made up for that?

Q. Surely. You had it made up recently?

A. Yes, in the last day or two, as of the end of 1937.

Q. '36? Or '37, I should say.

A. '37. That is right. There appeared on the records of the company to be 290,476 shares in my name. Of that amount, 189,120-1/2 shares are what are termed escrow shares. They are shares that have never been released and are tied up by reason of the Commissioner of Corporation's order, and of that amount, of that 189,120 shares, Mr. Hanna and Mr. Morton owned 37,824 shares.

Do I make myself clear?

Q. Yes.

A. So that I owned of the escrowed shares 151,296, which would give me a total of approximately 250,000 shares, even though 290 appear of record

(Testimony of J. A. Smith.)

as mine. The exact number— [113] pardon me. The exact number is 252,632-1/2 shares.

Q. Now, when this well was abandoned—strike that.

When the No. 16 was quitclaimed by Barnhart-Morrow, did you immediately start to manage the well? A. Yes, I did, sir.

Q. What did you do?

A. Well, I had the men at the field try to pull the tubing and clean the well out. In that connection, and for your benefit and better understanding of the situation, let me say this, that about that time the sand, the Meyer sand out of which this well was producing, was giving a lot of trouble in that end of the field, with the result that for a year past and during that time liners were collapsing, and the total amount of oil that had been taken out of the sand had so depleted it that it was shifting under the ground. And I had two wells, one on the east of this and one on the west of this, both of which had collapsed liners in them, previous to this latter part of 1937. And this well had ceased producing and had sanded out and we couldn't pump it or anything of that sort.

Q. That was when it was owned by Barnhart-Morrow? A. Yes, sir.

Q. You also supervised its operation at that time?

A. Yes, sir. In fact, I have been supervising these wells since about 1932, first as a co-trustee and receiver, and sub- [114] sequently after the prop-

(Testimony of J. A. Smith.)

erty was turned back to the Barnhart-Morrow Company I operated as the general manager of the Barnhart-Morrow Company their wells and my own wells. I have other wells on the same premises. And we finally got the tubing and the rods out of the well, ran mangroves or wedges into the well and found that the liner had crumpled, but not totally collapsed. We wedged it out, which luckily was a very simple job. I think a matter of a day or two of swedging we had the liner in shape and it stood since then. It hasn't collapsed since, so the total amount of expense and physical effort in reconditioning the liner at that time was not serious; but it did cost in labor and materials some seven or eight hundred dollars at that time.

Q. That was while the property was yours?

A. That was after it was mine.

Q. After it was yours?      A. Yes, sir.

Q. Now, right prior to the time that the property was quitclaimed to you, had the well been operated much? Was the well operating?

A. Yes, sir.

Q. And was it your idea that the well could be continued in operation?

A. You can't have an idea about that. It is just a guess. [115] Let me say that about a year prior or more, maybe a year and a half prior to the end of 1937, and while the well was in the hands of myself as a trustee in the Superior Court, this well's liner collapsed and we spent as trustees something like 18 or 20 thousand dollars to do the same thing

(Testimony of J. A. Smith.)

that I happened to do in the end of 1937 with a very small amount of money.

Q. As the manager and actual operator of the well No. 16, did any of the directors of Barnhart-Morrow or other officers inquire of you as to the advisability of the continuance of its operation?

A. Oh, yes.

Q. What was your advise to them?

A. I told them that was something we couldn't tell until we got into it, which was correct as I understood it.

Q. And was it on that indefinite advice, if you understand what I mean, that Barnhart-Morrow quitclaimed the well to you?

A. Well, I can't say on what basis they quitclaimed. I can say this, that Mr. Hardison is one of the oldest oil operators in the state of California, the president of this thing. Mr. Morton is an oil operator in his own right, and the other men on the board are practical oil men that have operated in that vicinity.

Q. Did you make any definite recommendation with respect to [116] its continuance?

A. No, sir.

Q. Were you asked?

A. Yes, sir. We discussed the physical condition of the well and their largest concern was the fact that the well might require the expenditure of a large amount of money, and if it did, it would come out of their pocket. They had no way

(Testimony of J. A. Smith.)

of charging me. And they wanted me to take it over for that reason.

Q. Did you as a stockholder—were you also a director of Barnhart-Morrow?     A. Yes, sir.

Q. And as a director did you know that under the terms of the operating agreement that Barnhart-Morrow was bound to operate the well?

A. They were bound to as long as they chose to.

Q. As long as they chose to?

A. Yes. They weren't bound beyond that point. They had the right, as I understand it, to quitclaim the well at any point.

Q. And how soon after the well was quitclaimed to you did you proceed to take action to correct the defect in the well's operating facilities?

A. I don't think I understand it.

Will you read the question? [117]

(The question referred to was read by the reporter, as set forth above.)

The Witness: Well, practically immediately.

Q. (By Mr. Tonjes) Immediately?

A. Yes.

Q. And that resulted in a profitable production of oil?

A. Well, in a very minor sort of way, yes, sir.

Q. What do you mean by that? Can you give me some figures on that?     A. Yes, I can.

As a result of that we sold in January \$1500 worth of oil and gas approximately, and in February \$1500 worth and in March \$100 worth and in April \$2550

(Testimony of J. A. Smith.)

worth, in May, \$1,464 worth, and \$113 worth of gas, January \$1300, July \$1500. You want just approximate figures?

Q. Yes.

A. I am having difficulty reading these small figures.

And in September, \$1500; October, \$1300; November, \$1200; December, \$1300.

Q. That is fine.

A. It has been going down until now it is doing around seven or eight hundred. That is gross figures.

Q. Was that your share of the property?

A. No. My understanding is that that is gross figures, royalties and thinks like that are to be taken out. [118]

Q. As I understand it, when Barnhart-Morrow inquired of you as to the prospects of bringing the well into a profitable operating condition, you were unable to give a definite opinion?

A. Yes, sir.

Q. But on the other hand you turned right around and invested your own money in it and with an attempt to—

A. (Interrupting) That is right.

Q. Can you explain that? It appears to me to be a little bit inconsistent.

A. Maybe it does, but it isn't inconsistent to an oil man. When a well that has produced oil stops producing, that is the only thing you can do, is to

(Testimony of J. A. Smith.)

start to work on it. You don't know what is wrong with it even until you have worked on it. You can't on the other hand leave it there because of the state laws. The well has to be abandoned if you don't propose to recondition it and don't propose to produce it, and in connection with abandoning a well the cost of getting the well in condition to abandon might go from five to six thousand to ten thousand dollars. You don't know about that. And as I saw it, Barnhart-Morrow as a matter of fact shirked the liability of abandoning the well by turning it over to me. And yet they had the right to abandon it at any time they wanted to. When I say "abandon" it, I mean leave it. [119]

Q. Well then, under the method of operation of oil wells in the state of California, when a well is abandoned, it is likely to entail quite an expenditure of money? A. It may, yes, sir.

Q. And by the acceptance by you of the quit-claim, why, Barnhart-Morrow was relieved of any possibility of incurring any such liability, was it not? A. That is true.

Q. And would you say that was one of the things which motivated the transaction?

A. Well, I suppose that it did. I suppose that it was one of the factors that they took into consideration.

Q. Now, we are going now, Mr. Smith, to another subject. I don't know if you are familiar with it. This relates to that \$16,500 item. In the year 1936, shortly after the termination of the litiga-

(Testimony of J. A. Smith.)

tion, you presented a claim to Barnhart-Morrow Company, did you?      A. Yes, sir.

Q. And that was in the sum of what amount, do you recall? Was the amount approximately \$22,000?

A. I think it was something like that.

Q. And included in that was an item of \$16,-500.10, is that correct?      A. Yes, sir.

Q. Now, were you a director of Barnhart-Morrow in 1930 and [120] 1931?

A. No, sir.

Q. Were you a stockholder then?

A. No, sir.

Q. You were not associated with the company at all at that time?

A. No, sir, in no way at all.

Q. And when did you become a stockholder?

A. I am going to have to guess at that, because I honestly do not know. Mr. Meitner could probably help us with the books and records, but I think in 1930 or '33. It was during the course of the litigation in which the properties were involved and during the course of the litigation involving the Barnhart-Morrow Company as a separate lawsuit entitled Morrow v. Barnhart and Company.

Q. Yes.

Do you know when you became or recall when you became a director?

A. I didn't become a director until—no, sir, I don't know whether I became a director shortly after buying the stock or some time after buying

(Testimony of J. A. Smith.)

the stock, but it was during the time that the company was in receivership.

Q. The item in question, the sum of \$16,500.10 was set up as a demand by you on account of an acquisition of an interest of one Boyle? Is that correct? [121]

A. Yes, that is correct. It was Cady. I think it was Boyle technically but Cady.

Q. We will call it the Cady-Boyle interest.

You acquired the Cady-Boyle interest in that particular well?

A. Yes. I bought it at a bank in Pasadena. I did not deal with Mr. Cady in connection with that.

Q. When did you buy it?

A. I bought it—

Q. (Interrupting) When did you buy it?

A. I think the name of the bank was the Security Bank.

Q. Do you know when?

A. Pardon me. No. I didn't. It was in the same interval, approximately somewhere between '33 and '34, somewhere in there. Yes, '33 or '34. I am not sure.

Q. At that time did you know anything about the payment of the sum to Flesher?

A. No. I understood the account to be an account receivable of the Barnhart-Morrow Company and still due and payable. That was the way it was represented to me.

Q. Where did you find out about the question —when did you first discover that there had been

(Testimony of J. A. Smith.)

a payment made which represented a portion of the interest you had acquired?

A. Well, it was after acquiring it and I would say perhaps quite some time after I acquired it because the Barnhart- [122] Morrow Company itself and its books and records were in the hands of the receiver in the Superior Court, and while it is true I had some access to them in the sense that I could go talk to the receiver, we didn't discover, as far as I recall, we didn't discover that the payment of this money had been made until we actually got control of the books to the point where an audit was available and that audit was made by Mr. Meitner who was appointed by the Superior Court to audit the books of the Barnhart-Morrow Company. And I don't know when the audit was available. It was after a long period of time and it is difficult to say.

Q. Did you immediately advise Barnhart-Morrow of your acquisition of this interest at the time you acquired it?

A. I am certain in my own mind, and yet if you asked me for the argument, I am certain I couldn't produce it—it was in receivership. I am certain of that. I made certain demands on him so his records would be clear.

Mr. Tonjes: I think that is all of the questions of Mr. Smith.

The Witness: May I ask this: I have been trying to do some other business—

Mr. Burkhead (Interrupting): Just a minute.

The Witness: Pardon me.

(Testimony of J. A. Smith.)

Mr. Tonjes: We will agree, your Honor, that the assignment of the Cady and Boyle interest to Mr. Smith was in 1931; [123] that fact is stipulated.

Mr. Morton: Yes. Exhibit 35.

### Cross Examination

Q. (By Mr. Burkhead) Mr. Smith, after Well 16 was quitclaimed to you and you took it over, did any stockholder of Barnhart-Morrow Consolidated have any interest in that well with you, any interest at all? A. No, sir.

Q. Never have had? A. No.

Q. Did Barnhart-Morrow Consolidated have any further interest or claim any further interest after that quitclaim? A. No, sir, none whatever.

Mr. Burkhead: That is all.

The Member: Mr. Smith, let me ask you a question or two to clear my mind up a bit.

First as to the well, what was the first thing you did to recondition this well after you took it over??

The Witness: Well, sir, I pulled the tubing and the rods after considerable difficulty and that difficulty was due to the fact that the casing—not the casing, but the liner, which is a perforated section of casing—had collapsed sufficiently so as to pack the sand tightly about the tubing. And I succeeded in getting the tubing out. That is the job or that is the problem. And then swedged it with [124] tools so as to bring it back to its original size.

The Member: You ran something down through it and washed it out?

(Testimony of J. A. Smith.)

The Witness: Yes, that is something that might take place with a certain amount of work and stay in place, or to my own experience and in my own experience that is something that might not work at all. In other words, you might swedge it out and as soon as you put the well on production it might not only collapse to the same degree that it had collapsed previously, but might collapse totally.

The Member: The first thing you wanted to know was what was the situation down there?

The Witness: That is true.

The Member: How much expense did that entail in finding that out?

The Witness: Practically all I spent on it. In other words the repair work in this instance was lucky, because it was one that stood rather than stood temporarily.

The Member: What I am wondering is, it occurred to me just a bit queer that the company of Barnhart-Morrow didn't make some investigation to find out what the condition was. Now, clear that up, if you can.

The Witness: They were operating the well at a loss anyhow. As a matter of fact, for the year, they were operating the well for my benefit as a matter of fact. They were get- [125] ting no return out of it. And now they were confronted with spending a hundred dollars, a thousand dollars, or some amount of money, that was indefinite, assuming that they could repair it for \$500 or less than

(Testimony of J. A. Smith.)

I did. They still couldn't make any money out of the well. They couldn't make any money out of the production I got out of it. It would still be a loss to them.

The Member: It occurred to me to wonder why they had not made some investigatory activities.

The Witness: May I add this: this field and this zone was as of that time and now even more so a depleted sand to a point where you know that the production is but a small amount of production.

The Member: So much for that.

How did you come to buy this \$23,000 plus item receivable out of which the \$16,000 was taken that you required from this Pasadena bank?

The Witness: At that I was buying any claim against this property. I mean any claim that appeared to be an interest in the production of the oil to be obtained from this property, and Mr. Cady had this claim and this was but one interest that he had. I mean this \$16,000 account. In fact, I acquired my half interest in the well 16, an interest in the well 17, and the account receivable from Mr. Cady.

The Member: What investigation, if any, did you make [126] before you bought these items such as this one, what they were worth? In other words, I am wondering whether you purchased this without investigation as to whether some portion of it had been already paid. I have these doubts in my mind and I am giving you a chance to clear them up.

The Witness: I can't say that I made an investigation as to whether or not the \$16,000 was due. I

(Testimony of J. A. Smith.)

was acquiring a half interest in Well No. 16 and I was acquiring—I would say a half interest; it is a half of the operator's interest, not a half net—and I was acquiring an interest in Well 17.

The Member: You mean you bought those all as one item?

The Witness: Yes, sir.

The Member: Those matters together as one item, they totalled about \$22,000?

The Witness: No. I didn't pay that much for it. I presented a claim to Barnhart-Morrow Company for 22 or 23 thousand dollars. I don't know the exact amount of it, but that represented other moneys advanced.

The Member: Did you have any reason at the time you purchased these items to question whether the \$16,000 item was payable or would be paid or any doubt about the title to your right to it, so to speak?

The Witness: Well, as I say, I can't say that I made an investigation as to whether it had been paid. It just didn't [127] occur to me that it would have been paid, in the first place; and I bought the three things together. I mean the two interests in the wells and the accounts receivable. That is the way I dealt with it.

The Member: That is all.

Mr. Burkhead: May I inject at this time—I think it will help the record—that the Cady assignment he is talking about is Exhibit 35(a) and the demand that he referred to is Exhibit 45(a). It

(Testimony of J. A. Smith.)

might help the Court when he reads the testimony.

The Member: Yes. It will. That is all.

The Witness: Is there any possibility that I may be needed any further?

Mr. Tonjes: Not on my behalf.

The Witness: I will be very glad to come back; if not, I would like to be excused.

Mr. Burkhead: You may be excused.

The Member: You may be excused for the rest of the time.

The Witness: Thank you, sir.

(Witness excused.)

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### GEORGE F. MEITNER

a witness on behalf of petitioner, was duly sworn and testified as follows:

The Clerk: You will tell us your name, please, Mr. [128] Witness.

The Witness: George F. Meitner; M-e-i-t-n-e-r.

Mr. Morton: Your Honor, inasmuch as I won't participate further in the matter, and counsel, unless you or Mr. Tonjes thought you might want me as a witness, I would prefer to withdraw.

The Member: I don't know of any reason why you should stay.

Mr. Morton: If there is any question you would like to ask me about anything, I will be glad to remain.

(Testimony of George F. Meitner.)

Mr. Tonjes: I don't think so.

The Member: Very well. You are excused.

We will recess for five minutes at this time before we start with this witness.

(At this point a short recess was taken, after which proceedings were resumed as follows:)

Direct Examination

Q. (By Mr. Burkhead) Mr. Meitner, what is your occupation or business?

A. Certified public account.

Q. Did you act as auditor for the Barnhart-Morrow matters? A. I do.

Q. When were you first engaged in that work for them?

A. I was first appointed by the Superior Court of the County of Los Angeles, State of California, in the matter of D. R. [129] Morrow v. Barnhart-Morrow Consolidated and others in September 1931, I believe, if my memory serves me correctly.

Q. You were acting in the capacity of an auditor for the receiver in that particular matter?

A. I was.

Q. After that time did you make any reports for the receiver or act as auditor for the receiver in the matter of Julian v. Schwartz?

A. I did.

Q. I see.

I will state for the purpose of the record, at this point, that those two audit reports have been referred to in the stipulation and are attached as

(Testimony of George F. Meitner.)

exhibits in the stipulation heretofore filed, one having been dated in February of 1937, and the other in September of 1937.

The Member: Can you name the exhibit numbers without too much looking it up? That will help, if you can.

Mr. Burkhead: I can get them right here, if the Court please.

The audit report of February of 1937 is Exhibit No. 48, and the one of September 1937 is Exhibit No. 49(a).

Q. Mr. Meitner, are you thoroughly familiar with the books and records of the receiver and co-trustees that were kept for the Barnhart-Morrow Company, and other books of the Barnhart-Morrow Consolidated? [130]

A. I am.

Q. You spent considerable time in going over those books through the various years?

A. I have.

Q. The audit reports that you have prepared and referred to as Exhibits 18 and 49(a) were prepared by you from those books?

A. They were.

Q. And the various statements that you may perhaps have re-referred to in the balance of your testimony were prepared by you from the books of Barnhart-Morrow Consolidated, the co-trustees and receivers?      A. That is right.

Q. Do you have the originals of those books here in court?      A. I have.

(Testimony of George F. Meitner.)

Q. Now, with reference to the \$7,000 item, the salary item of Mr. Hardison, that is, the accrued payroll item of \$14,000, which was, may I say, settled by the petitioner herein by paying to Mr. Hardison \$7,000, and not paying the other \$7,000, will you state just how the \$7,000 item that was not paid to Mr. Hardison was handled and shown on the books of the corporation?

A. Well, at the time I made the audit for the receiver in Barnhart-Morrow Consolidated—

Mr. Tonjes (Interrupting): One suggestion I might make, [131] you Honor. We have here a receiver and a trustee and a corporation. I think that it might make the record clearer if this witness refers to the books of which particular one of those three he has reference to when he answers questions, and the questions the same way.

The Member: It would be helpful no doubt if you can.

Mr. Burkhead: Very well. I will try to do that.

Q. Let's get that book situation straightened out right now, Mr. Meitner.

Were there more than one set of books or were there all the same set of books but in the charge of different persons at different times?

A. Well, there are two separate sets of books involved. There is Barnhart-Morrow Consolidated, a corporation, and its separate set of books, and then the separate books of C. L. Olson and J. A. Smith as co-trustees in the matter of Julian v. Schwartz.

(Testimony of George F. Meitner.)

Q. Then, reframing my question with reference to the \$7,000 item, Mr. Hardison's salary, that item would be reflected on the books of Barnhart-Morrow Consolidated, is that correct?

A. That is correct.

Q. Now, will you state in what way that was reflected and how it was handled from a bookkeeping standpoint?

A. At the time I made the audit for Ralph S. Armour, A-r-m-o-u-r, receiver for Barnhart-Morrow Consolidated in the [132] matter of D. R. Morrow v. Barnhart-Morrow Consolidated, there was accrued on the books of Barnhart-Morrow Consolidated to July 31, 1931, salary in the amount of \$14,000. That remained set up on the books of the corporation until December 1936 when \$7,000 was paid to Mr. Hardison and the balance of the \$14,000 which had been set up as an accrual was cancelled by myself through a journal entry on the books and \$7,000 was credited to surplus. At that time the books actually in fact show a deficit.

Q. In other words, through a journal entry you credited the \$7,000 liability cancelled to surplus, did you not?      A. That is right.

Q. As of what year did you cancel the \$7,000?

A. In 1936 I made the entry.

Q. As of that year?

A. Well, I believe the entry refers to a retroactive cancellation.

Q. To what year?

A. To the year 1931.

(Testimony of George F. Meitner.)

Q. From your knowledge of the books of the corporation and the financial affairs of that company, did the corporation derive any benefit from that cancellation for the year 1931?

Mr. Tonjes: That is objected to, your Honor.

The Member: Upon what ground?

Mr. Tonjes: On the ground that it calls for a conclusion [133] of the witness, that as to whether or not the corporation obtained any benefit is something that rests with the Board's determination, the Board's judgment, and not this witness'.

The Member: It seems to me that that objection is well taken. It calls for a conclusion on the part of this witness. Objection sustained.

Q. (By Mr. Burkhead) Mr. Meitner, do you know from your knowledge of the books of the Barnhart-Morrow Consolidated whether or not that company sustained a loss for the year 1931?

A. They sustained a loss somewhere in the sum of \$90,000 for the year. I believe the amount is set forth in the stipulation of facts.

Mr. Tonjes: That is stipulated, your Honor.

Q. (By Mr. Burkhead) Now, with reference to the \$16,500.10 that has been talked of heretofore as having been first paid to Mr. Flesher and later paid to Mr. Smith following the judgment in Julian v. Schwartz, how was that item \$16,500.10 handled on the books of the corporation from a bookkeeping standpoint? Will you trace those entries that you made?

(Testimony of George F. Meitner.)

A. Well, the sum of some \$22,000 which was paid to Mr. J. A. Smith I believe in November of 1936 was charged to accrued royalties. In that account there had been accrued prior to that time a balance of royalties that had accumulated from the production of Julian Well No. 16 prior to the time that such [134] well was involved in the litigation of Julian v. Schwartz. In view of the fact that there had been theretofore paid to Flesher, in fact, in the year 1930 there was paid to H. B. Flesher, the sum of \$16,500.00, and since there was not sufficient accruals in the royalty accrual account to cover the amount which was paid to J. A. Smith, I made an entry crediting royalties accruable for the sum of \$16,500.10 and charged it off to miscellaneous losses, which account in turn was charged off to profit and loss in the year 1936.

Mr. Burkhead: Handing counsel a copy, I offer in evidence as Petitioner's Exhibit 56 a certified copy of the stipulation for dismissal of receiver and agreement regarding operation of wells and impounding of funds pendente lite in the case of Julian v. Schwartz in the Superior Court of the State of California, No. 315-345. The only purpose of offering this is to show that in that stipulation and order it was provided that separate accounts of production and expenses of operation of each of said wells shall be kept.

Mr. Tonjes: No objection.

The Member: This will be No. 56.

The Clerk: That is correct, your Honor.

(Testimony of George F. Meitner.)

The Member: Admitted in evidence as Petitioner's Exhibit No. 56. [135]

(The said stipulation, so offered and received in evidence, was marked Petitioner's Exhibit 56, and made a part of this record.)

Q. (By Mr. Burkhead): Now, Mr. Meitner, were separate accounts made of each and every well in which Barnhart-Morrow had an interest and which were involved in this litigation?

A. You are referring now to the receiver's records, the trustee's records of Olson and Smith?

Q. That is correct.

A. The bookkeeper keeping the records for C. L. Olson and J. A. Smith, co-trustees in the matter of Julian v. Schwartz involving Julian Wells 1, 2, 3, 11, 16, and 17, gets the income or proceeds from the production of oil separately by wells and also kept the expenses of operating such wells separately by wells.

Q. I show you a document entitled "Barnhart-Morrow Consolidated gross income expense, depletion, net income" for the year ended December 31, 1937, and I will ask you if you will examine it.

A. (Examining document): I prepared this statement, this document.

Q. From what did you prepare it?

A. From the books of the company.

Q. In your opinion is it a true reflection of the books of the corporation, of the company?

A. This statement here reflects the income and

(Testimony of George F. Meitner.)

expenses of the [136] company for the year 1937, taking into consideration such minor items—

Mr. Tonjes (Interrupting): I object to the witness describing the document which is not in evidence, your Honor.

Mr. Burkhead: I am trying to lay a foundation to get it into evidence, your Honor.

Q. Does that document show the income and expenses, operating expenses, with respect to each well separately for the year 1937?

A. It does.

Q. You took those figures and prepared that document from the original records of the company?

A. I did.

Mr. Burkhead: I offer that as Petitioner's Exhibit No. 57, if the Court please. A copy has been presented to counsel.

Mr. Tonjes: The respondent *rejects* to the offer, your Honor, for the reason that it goes further in that it sets forth additional matters to those stated by the witness. It attempts to show what is a proper depletion allowance and respondent objects to it for that reason. I think that if the offer or the document is revised so as to—

Mr. Burkhead (Interrupting): I withdraw that. That is not the purpose I had in mind at all. I withdrew the offer of the exhibit and will go at it in this way: [137]

Q. Mr. Meitner, can you state the income that Barnhart-Morrow received from Well No. 16 during the year 1937?

(Testimony of George F. Meitner.)

A. The total gross income reflected on the records is \$10,349.87 from proceeds from their operation of Well 16 during the year 1937.

Mr. Tonjes: May I confer with counsel for a moment, your Honor?

(Conference between counsel.)

Q. (By Mr. Burkhead): From the proceeds of the oil Barnhart-Morrow received from Well No. 16 we paid out a certain amount of royalty interest to the third party, is that correct?

A. That is right.

Q. And what was the amount of that?

A. \$2,885.14.

Q. That would leave the net amount of oil and gas revenue from Well No. 16 to Barnhart-Morrow Consolidated for the year 1937 as \$7,464.73, is that correct? A. That is correct.

Q. What was the amount of the well operating expenses as to Well No. 16 for the year 1937?

A. Operating costs and maintenance was \$6,134.73.

Q. What other expenses did Barnhart-Morrow pay for that Well 16 for the year 1937?

A. There was general field overhead expense of the Santa [138] Fe Springs field which involved Julian Wells 1, 2, 3, 11, 16, and 17, of which the proportion charged to Well 16 was \$1,536. The proportion of general administrative expense which was charged to Well 16 was \$1,503.14. Mining rights, taxes, State Oil and Gas fund taxes, and personal

(Testimony of George F. Meitner.)  
property taxes which were paid out for Well No. 16 is \$468.10.

Then a loss sustained on tubing collapse on Well 16 in the year 1937 amounts to \$1,081.54.

Mr. Tonjes: If your Honor please, in the interest of saving the Court's time, might I state that the document offered by counsel for the petitioner sets forth the operating result of several wells and counsel is evidently going to go down the line and show all of these figures.

Mr. Burkhead: I am through right now.

Q. That makes a total of \$10,723.51 overall operating cost as to well 16 for the year 1937?

A. That is correct.

Q. Which leaves a net operating loss before deductions for depletion allowance in the amount of \$3,258.78, is that correct?

A. That is correct.

Q. That was the condition of the Well No. 16 as of about December 20, 1937, is that correct?

A. That is the operating loss to that date.

The Member: What is the date when Smith took it over? [139]

The Witness: I think it was quitclaimed on December 20th and this takes all expenses of operation down to that date. I think the well went off of production on December 17th.

Q. (By Mr. Burkhead): May I ask the witness to point out to me the statement which I think you have prepared showing that \$42,000 item that is claimed as a loss on that well?

(Testimony of George F. Meitner.)

A. On the same statement.

Q. Can you state briefly how the figure of \$43,-151.96 claimed as a loss on Well 16 was arrived at and established?

Mr. Tonjes: Claimed as a loss on what?

Mr. Burkhead: On the abandonment of Well 16.

Mr. Tonjes: In the petition?

Mr. Burkhead: That is right.

The Witness: Well, from the books of the corporation I prepared this agreement—this exhibit, showing tangible well equipment of \$26,890.37, less the cost of easing and tubing collapse at March 1937 of \$5,959.12, making the net original return for well equipment cost as set up on the records \$20,931.25.

Q. (By Mr. Burkhead): Maybe I can shorten this. Is this tabulation that I hand you now, does it reflect the figures and the manner in which you arrived at that figure, total figure of \$43,151.96?

A. It does.

Q. And the figures appearing on this statement, did you take [140] those from the books of Barnhart-Morrow Consolidated? A. I did.

Mr. Tonjes: Might I ask the witness a question or two?

Mr. Burkhead: Yes.

Mr. Tonjes: Mr. Meitner, in determining this figure of \$43,151.96, you obtain all these figures from the books of Barnhart-Morrow?

The Witness: Yes, I believe I have got all the figures set up there at the time I made the audit.

(Testimony of George F. Meitner.)

Mr. Tonjes: Did some of the figures come from the books of the trustee?

The Witness: No, they didn't.

Mr. Tonjes: You state that there has been claimed a deduction for depletion on December 31, 1935, in the amount of \$28,472.01. Where did you get that figure?

The Witness: That is on the books of the corporation.

Mr. Tonjes: What does it represent?

The Witness: It is depletion that had been accrued on production in prior years up to December 31, 1935, referring to that \$28,472.01.

Mr. Tonjes: That depletion represents depletion during the period in which the trustees operated the wells?

The Witness: No. That practically represents the depletion up to the time that the wells were taken over by the trustees. In other words, it is in the early years of production of Well No. 16.

Mr. Tonjes: That is depletion sustained prior to the time the trustees took over the operations of the wells?

The Witness: That is correct.

Mr. Tonjes: And do you know whether or not that corresponds with the depletion figure deducted from the income tax return for this corresponding period?

The Witness: Yes, I do.

Mr. Tonjes: Did you check that?

(Testimony of George F. Meitner.)

The Witness: Yes, I did. In other words, in my conferences back in Washington it may be that this might have a little depletion with respect to gas production of well—no, because Well 16 wasn't involved in that. This is all prior to the time the receivers took over the operation of that well.

Mr. Tonjes: And the two figures immediately following, depletion on Olson and Smith distribution of 1936 of \$9400 and eight thousand odd dollars, how did you ascertain that figure?

The Witness: Those were calculated by me on the amount of gross proceeds of the oil which had been credited the Barnhart-Morrow by Olson and Smith in the report that I prepared for that receivership.

Mr. Tonjes: In other words, that represents depletion?

The Witness: As I calculated it. [142]

Mr. Tonjes: For a period during which Barnhart-Morrow did operate the wells?

The Witness: That is right.

Mr. Tonjes: I have no further questions.

Mr. Burkhead: I will offer this document as Petitioner's Exhibit 56, for the purpose of showing the method and the manner in which petitioner arrived at the figure \$43,151.96 which the petitioner has claimed to have sustained as a loss on Well No. 16 at the time it was abandoned in 1937 and not for the purpose of showing that it is evidence of the fact that they did sustain that, but to show how we arrived at that figure, to show our method of computing.

(Testimony of George F. Meitner.)

Mr. Tonjes: It is objected to in the form offered as being immaterial.

The Member: The objection is overruled. It may not be highly material, but it occurs to me that for that purpose it may be helpful.

Now, Mr. Clerk, what is your number? The last number was not used.

The Clerk: If your Honor please, No. 56 was the last one which was admitted in evidence.

The Member: 57 was referred to, but not offered.

Mr. Burkhead: I withdraw the offer.

The Member: Not even identified.

This will be No. 57. Admitted in evidence as Petitioner's [143] Exhibit No. 57 for the purpose stated by counsel.

(The said document, so offered and received in evidence, was marked Petitioner's Exhibit No. 57, and made a part of this record.)

(Testimony of George F. Meitner.)

COMPETITIONER'S EXHIBIT No. 57

## BARNHART-MORROW CONSOLIDATED

**LOSS ON OIL WELLS QUIT CLAIMED AND/OR  
ABANDONED IN YEAR 1937**

JULIAN WELL No. 16

Tangible Well Equipment .....	\$ 26,890.37
Less—Casing and tubing collapse March 1937 .....	5,959.12
Net original tangible well equipment cost .....	
Casing and tubing replacement June 1937 .....	
Oil Tanks .....	1,300.00
Engines .....	1,038.72
Total Tangible Equipment .....	32,804.23
Less:	
Depreciation provided—Total .....	22,767.06
Deduct: Depreciation on casing and tubing collapse .....	4,877.58
Net Depreciation Reserve 12-20-37 .....	17,889.48
Depreciated Cost of Tangible Equipment .....	

(Testimony of George F. Meitner.)

## Petitioner's Exhibit No. 57—(Continued)

Intangible Drilling Cost				
Labor .....	22,818.89			
Hauling .....	2,443.01			
Fuel, Power & Water .....	2,632.56			
Repair Materials .....	3,411.31			
Supplies .....	22,559.79			
Tool & Equipment Rental .....	7,920.69			
Miscellaneous .....	4,878.50			
Drilling Tools Expense .....	3,898.30			
Depreciation on Drilling Equipment.....	3,604.26			
	<hr/>			
Total Intangible Well Costs .....	74,167.31			
Less:				
Depletion provided on Well No. 16				
Depletion Reserve Dec. 31, 1935.....	28,472.01			
Depletion on				
Olson & Smith Distributions in 1936 .....	9,407.29			
Olson & Smith Distributions in 1937 .....	8,050.80			
	<hr/>			
Total Depletion Reserve 12-20-37 .....	45,930.10			
	<hr/>			
Net Intangible Drilling Costs.....	28,237.21			
	<hr/>			
Net loss sustained by Company on abandoning and quit claiming its 50% of 80% Interest in Well No. 16 to J. A. Smith on Dec. 20, 1937 .....	\$ 43,151.96			

Net loss sustained by Company on abandoning and quit claiming its 50% of 80% Interest in Well No. 16 to J. A. Smith on Dec. 20, 1937 .....

(Testimony of George F. Meitner.)

## Petitioner's Exhibit No. 57—(Continued)

## DAVIES LEASE

Cost of Lease acquired 2-10-37 .....	\$ 2,000.00
Escrow Fees, Title and Recording Costs.....	116.75
<b>Total Lease Cost .....</b>	<b>\$ 2,116.75</b>
Cost of uncompleted well acquired by purchase from L. G. King.....	11,000.00
Water and Gas Lines .....	1,035.68
<b>Redrilling Costs</b>	
Labor .....	3,387.91
Hauling .....	1,099.46
Fuel, Power & Water .....	1,364.35
Repairs .....	473.03
Supplies .....	2,310.16
Tool & Equipment Rental .....	1,220.06
Insurance .....	262.96
Miscellaneous .....	588.79
Depreciation on Drilling Equipment .....	476.27
Field Overhead Allocated .....	1,456.63
<b>Total Well Costs .....</b>	<b>24,675.30</b>
<b>Total Lease and Well Costs .....</b>	<b>26,792.05</b>

(Testimony of George F. Meitner.)

## Petitioner's Exhibit No. 57—(Continued)

Less: Cost of Lease acquired.....	2,116.75
Estimated Salvage Value of Equipment.....	857.17
Total .....	_____
	2,973.92
Loss sustained on Davies-King Well No. 1 abandoned as a dry hole on April 27, 1937 .....	\$ 23,818.13

Geo. F. Meitner &amp; Co., Auditors and Accountants

[Endorsed]: U.S.B.T.A. Filed Oct. 4, 1941.

(Testimony of George F. Meitner.)

Q. (By Mr. Burkhead) Mr. Meitner, will you state how the mechanics from a bookkeeping standpoint of this \$43,151.96 was reflected by you on the books of the corporation?

A. Well, an entry was made charging off the equity remaining balanced, the difference between the cost value of the tangible equipment and the intangible drilling cost of the well less the reserve for depreciation on the tangible equipment, and the depletion reserve on the intangible equipment to arrive at, charged off as a loss to profit and loss on the company's records.

Q. In the year 1937? A. In the year 1937.

Q. For your information, Mr. Meitner, the stipulation of facts filed herein, together with the exhibits, contains an Exhibit No. 51 designated Balance Sheet of Barnhart-Morrow Consolidated for the years 1930 to 1935. From your knowledge of the affairs of Barnhart-Morrow Consolidated, the books of the corporation, was there any change in condition of Barnhart-Morrow Consolidated during the year 1936 up to the time that they received the funds from the co-trustees on or about November 14, 1936?

The Member: You said "condition." You mean financial [144] condition?

Mr. Burkhead: I refer to the financial condition of the company.

Q. In other words, did they receive funds from some source or did they pay out funds or did their

(Testimony of George F. Meitner.)

balance sheets and affairs remain about the same during that part of the year?

A. They remained about the same.

Q. I hand you another statement which has been heretofore presented to me and ask you if you can identify it.

A. (Examining document): This is a statement I prepared from the audit report that I submitted in the Olson and Smith trusteeship in the matter of Julian v. Schwartz.

Q. You refer to the audit reports that are in evidence as Exhibits 48 and 49(a)

A. I do. And it shows, as taken from those exhibits throughout that report and the schedules therein, what the total credits were to Barnhart-Morrow Consolidated from the proceeds from oils sold, together with a small item of cash discount on purchases which was credited to Barnhart-Morrow and a small amount of revenue which they received from the sale of junk which was credited to Barnhart-Morrow Consolidated, and two items which are not reflected on those two particular reports, but constitute income constructively received by the company in connection with the litigation of Julian v. Schwartz. [145]

Q. Wait a minute, Mr. Meitner. Can you tell the Court this: State the total amount of proceeds received from the sale of oil and gas by the co-trustees which was allocated to Barnhart-Morrow Consolidated?

(Testimony of George F. Meitner.)

A. Yes. In the audit report of 2-9-37, schedule 1, page 17 of that report, there is a total amount of gross proceeds from oil sales credited to Barnhart-Morrow Consolidated of \$400,690.99, and showing the distribution of that amount to Well No. 1 of \$126,624.21; Well No. 2, \$139,973.37; Well No. 3, \$115,783.37; Well No. 11, \$18,310.04.

With respect to Julian Well No. 16, the gross proceeds are \$63,338.64, and with respect to Well No. 17 the gross proceeds credited to the account of Barnhart-Morrow Consolidated is in two parts, the first part being in the sum of \$14,839.94, and the second amount being \$49,866.31.

Mr. Tonjes: Mr. Meitner, is this schedule a part of any of the exhibits which are in evidence?

The Witness: Yes. These references which I have on this exhibit refer back to my audit report, which are Exhibits—I forget the numbers.

Mr. Tonjes: 48 and 49(a).

The Witness: Yes.

Mr. Tonjes: Is this particular document from which you are testifying now in evidence? Do you know?

The Witness: This is not in evidence that I know of. [146]

Q. (By Mr. Burkhead): But it is the breakdown showing the gross proceeds received by the co-trustees as to each well that was allocated to Barnhart-Morrow Consolidated as reflected by your audit report that is already in evidence, is that a correct statement?

(Testimony of George F. Meitner.)

A. Yes. It summarizes those total credits.

Mr. Tonjes: The figures on this document from which you are testifying are all obtained from the schedules now in evidence?

The Witness: All except the two pages shown on there.

Mr. Tonjes: What two?

The Witness: The gas revenues constructively received by the receiver in Julian v. Schwartz in 1931 and February and March of 1932 which was retained by the Texas Company and applied on the gas drilling contract liability of Barnhart-Morrow Consolidated to that company.

Mr. Tonjes: If your Honor, please, I move that the answer of the witness be stricken from the record on the ground that it merely states his conclusion; that it states his conclusion that all of the evidence, that is the basic facts, are taken from exhibits which are in evidence and this particular document from which the witness is now testifying also shows items constructively received. Well, that necessarily involves a legal conclusion as to when or whether money is or is not constructively received. I think that is argumentative. [147]

The Member: It seems to me that this witness can hardly decide a question of constructive receipt. The objection is sustained to that extent.

Mr. Burkhead: Well—

The Member (Interrupting): You are objecting and moving to strike that part of his answer that

(Testimony of George F. Meitner.)

refers to certain statements about constructive receipt of income, is that correct?

**Mr. Tonjes:** To the constructive receipt of the income on the ground that that is merely a conclusion of the witness, and the remaining part of the witness' answer on the ground that it is merely an expression of opinion, because he states that all of these figures are shown in the documents already identified and offered and received in evidence.

I don't know the purpose of his question if the facts upon which he bases his statements are in evidence.

**Mr. Burkhead:** Counsel, the purpose of this document is that it was thought that it might be of some help to the Board in that it is a breakdown of what is actually contained in the audit report, and I was trying to identify it and introduce it in evidence to show the breakdown so it might be helpful to the Court. The actual receipts of the co-trustees that were allocated to the Barnhart-Morrow Consolidated is in evidence. If you desire to let the record stand [148] the way it is, it is perfectly all right with me. It will be a little harder to point to it at a later time.

**Mr. Tonjes:** My objection was this, further, your Honor: The question involved here is the method for determining the depletion of Barnhart-Morrow Incorporated. The witness' answers lead to the conclusion that a certain amount of this oil was actually allocated to Barnhart-Morrow Company. I think the entire record and the documentary evi-

(Testimony of George F. Meitner.)

dence will show clearly that Barnhart-Morrow never was allocated any particular oil to any years. They were finally given a certain amount of dollars in the year 1936. They never had possession of any of this oil at all and it conflicts with the record as already established. If it doesn't, I hardly think that this witness is the proper way to show any facts which are inconsistent with the record.

The Member: Do you want to say something more, counsel for the petitioner?

Mr. Burkhead: I thought, if your Honor please, that I was by this document putting before the Board and in the record the gross proceeds received by those co-trustees from the sale of oil and gas that might be allocated or that would equal the percentage of interest that Barnhart-Morrow Consolidated had in those wells as established by those judgments. Now, we get that figure and that would be the figure that the petitioner contends it is entitled to use on which to base his [149] depletion. I was next going to ask this witness what the actual amount of cash that was paid over to Barnhart-Morrow by the co-trustees was. Then we have the figure that the defense says should be taken for the purpose of figuring depletion. From there on it seems to me it is a question of law as to which one should be taken. That is all the purpose that I have here and that is the two figures that I am trying to get into the record.

The Member: Is it true that document from which this witness is testifying and to which the

(Testimony of George F. Meitner.)

question as to which objection has been made is directed is a mere breakdown of the books and of what is already in evidence?

Mr. Burkhead: I understand it is a breakdown of the audit reports as to which we referred to as being Exhibits 48 and 49(a).

The Member: If it is a mere breakdown of that for the purpose of more clearly analyzing the situation or at least verifying it for the purpose of examination later, it seems to me that there is no prejudice in admitting it. I am not, of course, going to let the witness decide questions of constructive receipt, but the mere fact that this breakdown is placed before me doesn't indicate and, as admitted in evidence, does not indicate that I am going to allow that question to be decided by the witness or that his evidence is material in that regard. [150]

Mr. Tonjes: With that limitation, your Honor, I have no objection to the questions and I will go so far as to say that if this witness will testify that this is a statement prepared by him for the purpose of determining how much cash Barnhart-Morrow was entitled to, I will admit the document in evidence.

Mr. Burkhead: No, this is not the statement to show how much cash Barnhart-Morrow is entitled to. That is covered in another document, isn't it?

The Witness: No.

May I state that these amounts were all taken into consideration which resulted into the net cash which finally was paid to Barnhart-Morrow Consolidated.

(Testimony of George F. Meitner.)

Mr. Tonjes: Was the purpose of the preparation of this document to determine how much cash Barnhart-Morrow would get?

The Witness: That is right.

Mr. Tonjes: That was the only reason for its preparation?

The Witness: That is right.

Mr. Tonjes: I don't have any objection, that being the purpose of the document, your Honor, but I can't admit that these items which are classified constructive receipts and proceeds of oil allocated to Barnhart-Morrow as being proper.

The Member: Well, I don't understand that the instrument [151] or the testimony is offered as decisive upon that question. It is merely clarifying.

Your objection is overruled and exception allowed and the partial ruling in that regard is withdrawn. Exception allowed to the petitioner. I am receiving this instrument and this testimony as clarification of the books and the records already in evidence and as not decisive of any questions.

The Clerk: 58, if your Honor please.

The Member: Admitted in evidence as Petitioner's Exhibit No. 58.

(The said document, so offered and received in evidence, was marked Petitioner's Exhibit No. 58, and made a part of this record.)

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BARNHART-MORROW CONSOLIDATED

Gross Proceeds of Production from Julian Wells Nos. 1, 2, 3, 11, 16 and 17 for the Period December 1, 1930 to November 14, 1936 Being Gross Proceeds Received from Production by Chas. Allison and/or C. L. Olson and J. A. Smith, Receivers and/or Co-Trustees in the Matter of C. C. Julian v. Schwartz et al., Superior Court Case No. 315335, Credited to Barnhart-Morrow Consolidated; as Determined Pursuant to Judgment Rendered by the Court in Said Matter and Income Constructively Received by Barnhart-Morrow Consolidated in Said Matter.

Geo. F. Meitner & Co. Audit

Reports re C. L. Olson & J. A. Smith  
Co-Trustees - Julian v. Schwartz

Geo F Meitner & Co Auditors and Accountants

[Endorsed]: U.S.B.T.A. Filed Oct. 4, 1941.



(Testimony of George F. Meitner.)

The Member: I don't know that you have offered it yet. You were offering the questions with reference to it. Had you offered the instrument?

Mr. Burkhead: I will offer it at this time.

The Member: Very well. It is admitted in evidence as Petitioner's Exhibit 58.

Mr. Tonjes: The respondent perhaps had better remove his objections for the reason stated.

The Member: The objection is overruled and exception allowed the respondent.

Q. (By Mr. Burkhead): Mr. Witness, I show you a statement that is prepared in two parts, which purports to be distribu- [152] tions made by C. L. Olson and J. A. Smith, co-trustees of Julian Wells No. 1, 2, 3, 11, 16, and 17 in case No. 315345, to Barnhart-Morrow Consolidated pursuant to the judgment rendered and the orders of the court in that case referred to, and it also purports to contain income constructively received by Barnhart-Morrow Consolidated.

Now, with reference to those incomes constructively received, what do you understand to mean by constructive receipt. How were those incomes actually received? Will you explain what those incomes are and where they came from so that perhaps we can strike that word, that legal conclusion, constructively received?

A. Well, of the \$464.92 shown as 50 per cent of the sum of \$929.84, gas revenues as shown in my audit report of 2-9-37, all of the revenues by stipulation in the Julian v. Schwartz matter were released

(Testimony of George F. Meitner.)

to J. A. Smith, although Barnhart-Morrow Consolidated had an interest therein.

Q. In other words, on this document you have to J. A. Smith balance of cash revenues paid to Mr. Smith constructively received by Barnhart-Morrow Consolidated 50 per cent of \$929.84, the amount being that he received \$464.92. Now, you say that Barnhart-Morrow really was entitled to that gas revenue that was released to Mr. Smith, but you mean by constructively received that it should have gone through Barnhart-Morrow and then to Mr. Smith? [153]

A. That is right.

Q. The only difference is the fact that it skipped Barnhart-Morrow and went to Mr. Smith?

A. No. It went to Mr. Smith and then in the settlement, which is a part of the exhibits here, these items are all taken into consideration in that demand of Mr. Smith on Barnhart-Morrow.

Q. Now, this document has an item "Total Distributions to and Amounts Constructively Received by Barnhart-Morrow Consolidated in November 1936, \$142,989.99."

You arrived at that figure by considering a cash item paid to Ralph S. Armour, the receiver of Barnhart-Morrow, in the amount of \$17,852.13, and the actual cash paid to Barnhart-Morrow Consolidated by the co-trustees in 1936 was \$112,000, is that correct?

A. That is correct.

Q. And at the time the receivers turned the wells over to Barnhart-Morrow—I mean the co-trustees in November of 1936 pursuant to the judgment, they

(Testimony of George F. Meitner.)

also turned some equipment over to the Barnhart-Morrow, didn't they?

A. Yes, there was valuable equipment.

Q. Now, you set that equipment up on the books of Barnhart-Morrow and you have it on this statement at the depreciated cost value as of that time?

A. That is right. [154]

Q. In the amount of \$7,992.90?

A. That is correct.

Q. The co-trustees had on deposit some compensation insurance funds in the amount of \$300 and you charged that to Barnhart-Morrow?

A. That is correct.

Q. The gas item of \$464.92 we have covered.

To the Texas Company, gas revenues applied on drilling gas contract, you also set that up as having been constructively received by Barnhart-Morrow Consolidated in the amount of \$1,163.30. Did that not arise in this way, that the Texas Company withheld that amount and applied on a contract that they had with Barnhart-Morrow Consolidated?

A. That is correct. It was liquidating a liability of Barnhart-Morrow to them.

Q. And you called that constructive receipt of Barnhart-Morrow Consolidated, is the way you set it up here, is that correct? A. That is correct.

Q. Now, an item of A. L. Jameson, balance of oil royalty liquidated constructively received by Barnhart-Morrow Consolidated, \$2,699.63, will you explain why you call that constructive receipt?

(Testimony of George F. Meitner.)

A. This was a liability that had accrued to the books of Barnhart-Morrow to A. L. Jameson in the sum of \$2,699.63. [155] By a stipulation of the amount as to what sum would have to be recovered from the production of Well No. 17 before a different percentage of distribution was again to be used of distributing the proceeds of the production of that well to the holders of interest therein, the amount that was stipulated included this amount that was owned by Barnhart-Morrow Consolidated in the matter of Julian v. Schwartz, so that when that was liquidated through that trusteeship, it automatically liquidated one liability of Barnhart-Morrow to Jameson; and, therefore, with the elimination of that liability it automatically became income of Barnhart-Morrow, as I have termed here, constructively received by it.

Q. So that adding those amounts of actual cash received from what you call constructive receipts and the equipment, that is, depreciated cost value, the insurance premiums paid and so forth, you arrived at a figure of \$142,989.99 which you admit that the taxpayer received in the year 1936?

A. That is correct.

Q. And you have set this up on a schedule for the purpose of breaking it down and showing those various different items? A. That is correct.

Q. It is all included in your reports, or is it included in those audit reports?

A. Well, all of this is not included in those audit reports. Only those items that are specifically

(Testimony of George F. Meitner.)

marked here are in- [156] cluded here. In other words, the actual cash that was paid to the receiver, the actual cash paid to Barnhart-Morrow Consolidated, and the amount of the gas revenues that the trustees had, they were paid to J. A. Smith as shown in those audit reports.

Q. In other words, you have referred to those as exhibit B-11, and exhibit B-14. Those items are shown in the audit report?

A. That is correct.

Q. Where did you obtain the other figures?

A. The item of depreciated cost value of tangible equipment represents such assets that were acquired for the operation of the different wells that had a life longer than one year, and while the trustees kept their record clearly on a cash receipts and disbursements basis, these capital assets that were purchased were treated as material in repairs.

Q. Now, on this same instrument you have covered the year 1937, but I don't note that there were any constructive receipts during that year. You show various items totalling \$122,371.37 which represent the income of the taxpayer for the year 1937 as reflected by the cash paid, mining rights and taxes paid for its benefit, the cash having been paid from the co-trustees; is that correct?

A. That is correct.

Q. And also you have several columns here representing each [157] well by number with a figure beneath or in each column underneath each well number. What are those figures?

(Testimony of George F. Meitner.)

A. (Pause.)

Q. For instance, Well No. 1, \$38,039.82 for the year 1936.

A. Those are an allocation of the cash and other items there that were making up the \$142,989.99 which are based upon the total gross credits that were given to Barnhart-Morrow as shown on this exhibit previously presented, the aggregate total of all such wells being \$488,903.65.

Mr. Burkhead: I will offer this document as Petitioner's Exhibit next in order.

Mr. Tonjes: No objection.

The Member: Admitted in evidence as Petitioner's Exhibit No. 59.

The Clerk: That is correct, your Honor.

(The document, so offered and received in evidence, was marked Petitioner's Exhibit No. 59, and made a part of this record.)



## PETITIONER'S EXHIBIT No. 59

## BARNHART-MORROW CONSOLIDATED

Distributions Made by C. L. Olson and J. A. Smith, Co-Trustees of Julian Wells Nos. 1, 2, 3, 11, 16 and 17, in the Matter of C. C. Julian v. W. A. Schwartz, et al., Superior Court Case No. 315345, to Barnhart-Morrow Consolidated, Pursuant to Judgment Rendered and Orders of the Court in Said Matter, and Income Constructively Received by Barnhart-Morrow Consolidated, in and for the Years as Shown Reconciled with the Gross Credits to Barnhart-Morrow Consolidated and Charges Made Against Barnhart-Morrow Consolidated by the Co-Trustees in Said Matter of C. C. Julian v. W. A. Schwartz, et al.

Geo. F. Meitner & Co. Audit  
Co-Trustees - Julian v. Schwartz

Report re: C. L. Olson & J. A. Smith

Details	Date	Exhibit or Schedule	Page	Detail	Total	Well No. 1	Well No. 2	Well No. 3	Well No. 11	Well No. 16	Well No. 17
Received in year 1936					\$26,550.82	\$ 70,644.84	\$ 74,886.24	\$ 54,394.29	\$ 25,218.17	\$ 42,265.65	\$ 47,977.97
Cash paid to Ralph S. Arnour, Receiver for Barnhart-Morrow Consolidated	2-9-37	Exhibit B	11	\$ 17,852.13							
Cash paid to Barnhart-Morrow Consolidated	2-9-37	Exhibit B	11	112,000.00							
Depreciated cost value of tangible equipment acquired by Trustees of wells, possession of which was delivered on November 14, 1936 .....				7,982.90							
Compensation Insurance deposit assigned Liabilities of Barnhart-Morrow Consolidated through C. L. Olson & J. A. Smith, Co-Trustees:				300.00							
To J. A. Smith—Balance of gas revenues paid to Mr. Smith constructively received by Barnhart-Morrow Consolidated—50% of \$829.84 .....	2-9-37	Exhibit D	14	464.92							
To Texas Co.—Gas Revenues applied on Drilling (gas Contract—constructively received by Barnhart-Morrow Consolidated .....				1,163.30							
To A. L. Jameson—Balance of oil royalty liquidated, constructively received by Barnhart-Morrow Consolidated .....				2,699.63							
To C. L. Olson and J. A. Smith, Co-Trustees—Liability of Ralph S. Arnour, Receiver for Barnhart-Morrow Cons.—elated, cancelled by offset .....				517.11							
Total distributions to and amounts constructively received by Barnhart-Morrow Consolidated in November, 1936....					\$142,989.99	\$ 38,039.82	\$ 40,323.67	\$ 29,612.53	\$ 13,579.12	\$ 22,758.60	\$ 25,884.49
Received in year 1937											
Cash paid to Barnhart-Morrow Consolidated on February 28, 1937 .....	9-22-37	Exhibit B	8	63,000.00							
Mining rights taxes, State oil and gas fund taxes, Personal Property and other taxes paid for account of Barnhart-Morrow Consolidated in 1937 .....				1,333.43							
Cash paid to Barnhart-Morrow Consolidated on October 21, 1937 .....	9-22-37	Exhibit B	8								
Cash credit as of 9-15-37.....\$58,045.30	9-22-37	Exhibit A-1	6								
Add—cash collected subsequent to 9-15-37 .....				.62							
Total				58,045.92							
Less—Trustees Expenses											
9-15-37 to 10-21-37 .....				7.98							
Actual cash paid .....					58,037.94						
Total distributions to and amount constructively received by Barnhart-Morrow Consolidated during year 1937 .....											
Accounts Receivable .....	9-22-37	Exhibit A-1	6	190.08							
Less—Collection made subsequent to 9-15-37 .....				.62	189.46	50.40	53.43	39.24	17.99	30.15	34.23
Total distributions received by Barnhart-Morrow Consolidated .....											
\$265,550.82					\$ 70,644.84	\$ 74,886.24	\$ 54,394.29	\$ 25,218.17	\$ 42,265.65	\$ 47,977.97	

## PART 2—EXHIBIT No. 59

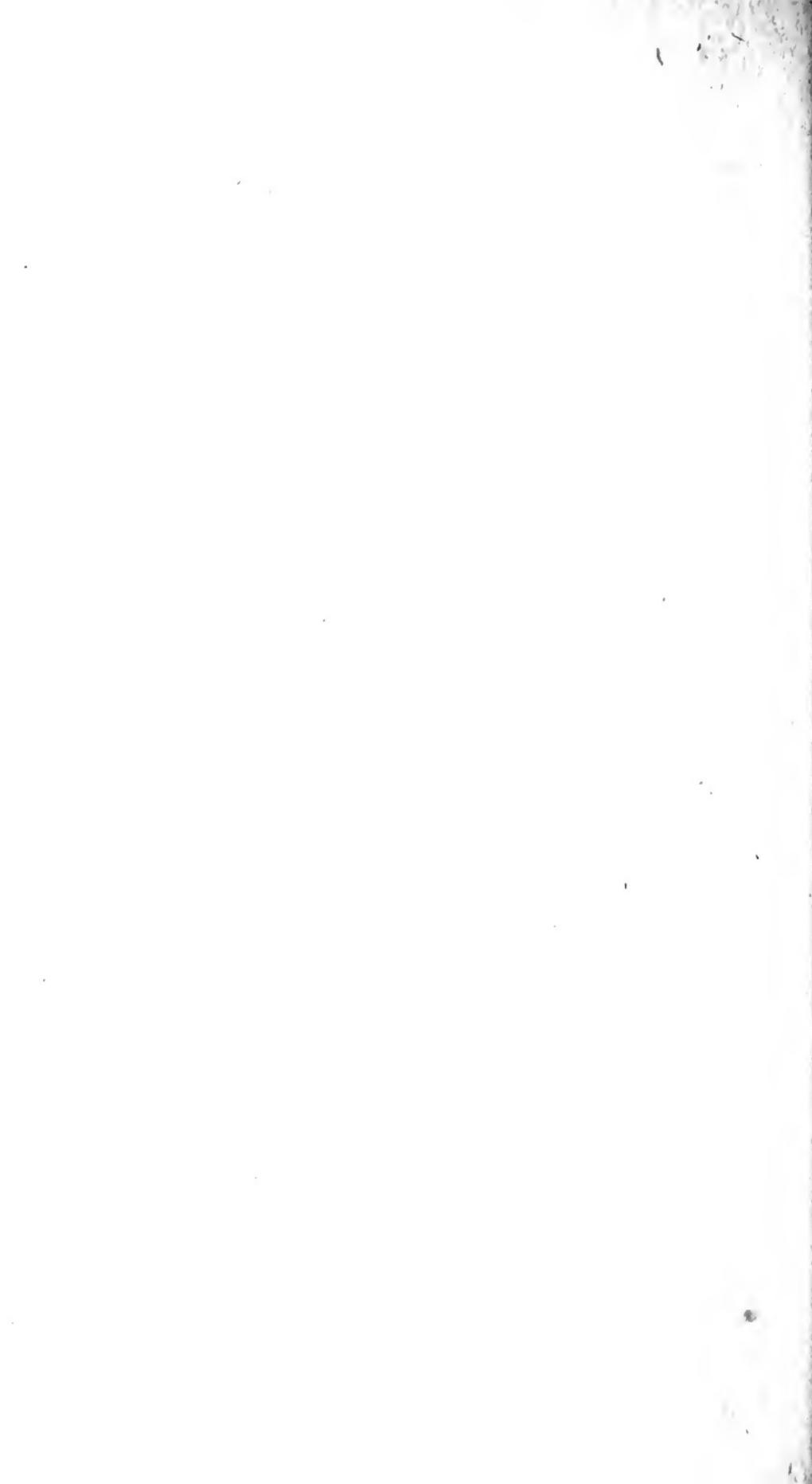
## BARNHART-MORROW CONSOLIDATED—(Continued)

Distributions Made by C. L. Olson and J. A. Smith, Co-Trustees of Julian Wells Nos. 1, 2, 3, 11, 16 and 17, in the Matter of C. C. Julian v. W. A. Schwartz, et al., Superior Court Case No. 315345, to Barnhart-Morrow Consolidated, Pursuant to Judgment Rendered and Orders of the Court in Said Matter, and Income Constructively Received by Barnhart-Morrow Consolidated, in and for the Years as Shown Reconciled with the Gross Credits to Barnhart-Morrow Consolidated and Charges Made Against Barnhart-Morrow Consolidated by the Co-Trustees in Said Matter of C. C. Julian v. W. A. Schwartz, et al.

Geo. F. Meitner & Co. Audit  
Report re : C. L. Olson & J. A. Smith  
Co-Trustees - Julian v. Schwartz

Details	Date	Exhibit or Schedule	Page	Detail	Total	Well No. 1	Well No. 2	Well No. 3	Well No. 11	Well No. 16	Well No. 17
<b>RECONCILEMENT</b>											
Total credits to Barnhart-Morrow Consolidated from gross proceeds from oil sales impounded, gas revenues constructively received, liabilities liquidated and other income credits by Co-Trustees of Julian Wells Nos. 1, 2, 3, 11, 16 and 17....					\$488,903.65	\$112,377.48	\$124,195.58	\$102,821.17	\$ 16,666.95	\$ 63,872.36	\$ 68,970.11
Total charges against Barnhart-Morrow Consolidated by Co-trustees of Julian Wells Nos. 1, 2, 3, 11, 16 and 17:											
Net charges applicable to expense of Well Operations .....					192,709.98	35,804.57	43,580.02	42,412.65	37,050.60	17,260.75	16,601.39
Taxes Paid .....					13,004.56	2,823.55	2,733.24	2,419.02	1,298.04	1,739.92	1,990.79
Receivers and/or Co-Trustees net expense					17,638.29	3,104.52	2,996.08	2,995.21	3,536.48	2,606.04	2,399.96
Total.....					223,352.83	41,732.64	49,309.34	47,826.88	41,885.12	21,606.71	20,992.14
Net credits to Barnhart-Morrow Consolidated received as set forth above.....					\$265,550.82	\$ 70,644.84	\$ 74,886.24	\$ 54,994.29	\$ 25,218.17	\$ 42,265.65	\$ 47,977.97

[Endorsed]: U.S.B.T.A. Filed Oct. 4, 1941.



(Testimony of George F. Meitner.)

The Clerk: Consisting of two pages.

The Member: It is now 12:00 o'clock, gentlemen. I have told the next case to be here at this time, with an idea of getting an idea about placing them on this docket when their case will come up. I would like to have your advice now as to how much longer this case will take, if you can give me any idea.

Mr. Burkhead: It isn't going to take me but I'd say 30 [158] minutes more and I will quit, if I use that much time.

Mr. Tonjes: I don't expect to have any lengthy cross examination, your Honor.

Mr. Burkhead: I am about to offer in evidence statements for the years 1936 and 1937 which are entitled "Gross Income, Expense, Depletion and Net Income for the Year Ended December 31, 1936," and the same thing for December 31, 1937. Now, in these two documents the author has set up an item depletion 27½ per cent of net amount of oil and gas revenues limited to 50 per cent of net operating profit.

It may be stipulated that that item in each of these documents and the figures set opposite that item may be disregarded entirely by the Board as though it did not appear upon the face of this instrument, and the same is true with reference to the words "Net Amount Subject to Income Tax of" which appears in the statement on the left margin of each of these documents opposite the figure \$73,-776.96.

The Member: Now, counsel, let me suggest that

(Testimony of George F. Meitner.)  
you run a line through that which you are striking, because otherwise I have to go to the record to see that it is stricken and might use it, or at least be confused in the using of it by having to go to the record to strike it. Just place a little notation that the part marked out is not offered, or something to that effect, and then I won't have any difficulty with it when I come to see this exhibit. [159]

Mr. Burkhead: With that limitation, I offer the document with reference to the year 1936 as the Petitioner's Exhibit No. 60, and the document with reference to the year 1937 as Petitioner's Exhibit No. 61.

Mr. Tonjes: No objection.

The Member: Petitioner's Exhibit Nos. 60 and 61 are admitted in evidence.

(The statements, so offered and received in evidence, were marked Petitioner's Exhibit 60 and 61, and made a part of this record.)

	Well No. 3	Well No. 11	Well No. 16	Well No. 17
<b>INC</b>				
Oi	2,521.50	\$ 316.59	\$ 4,561.79	\$ 2,496.51
W	----	----	----	----

## PETITIONER'S EXHIBIT No. 60

## BARNHART-MORROW CONSOLIDATED

GROSS INCOME, EXPENSE, DEPLETION AND NET INCOME  
FOR THE YEAR ENDED DECEMBER 31, 1936

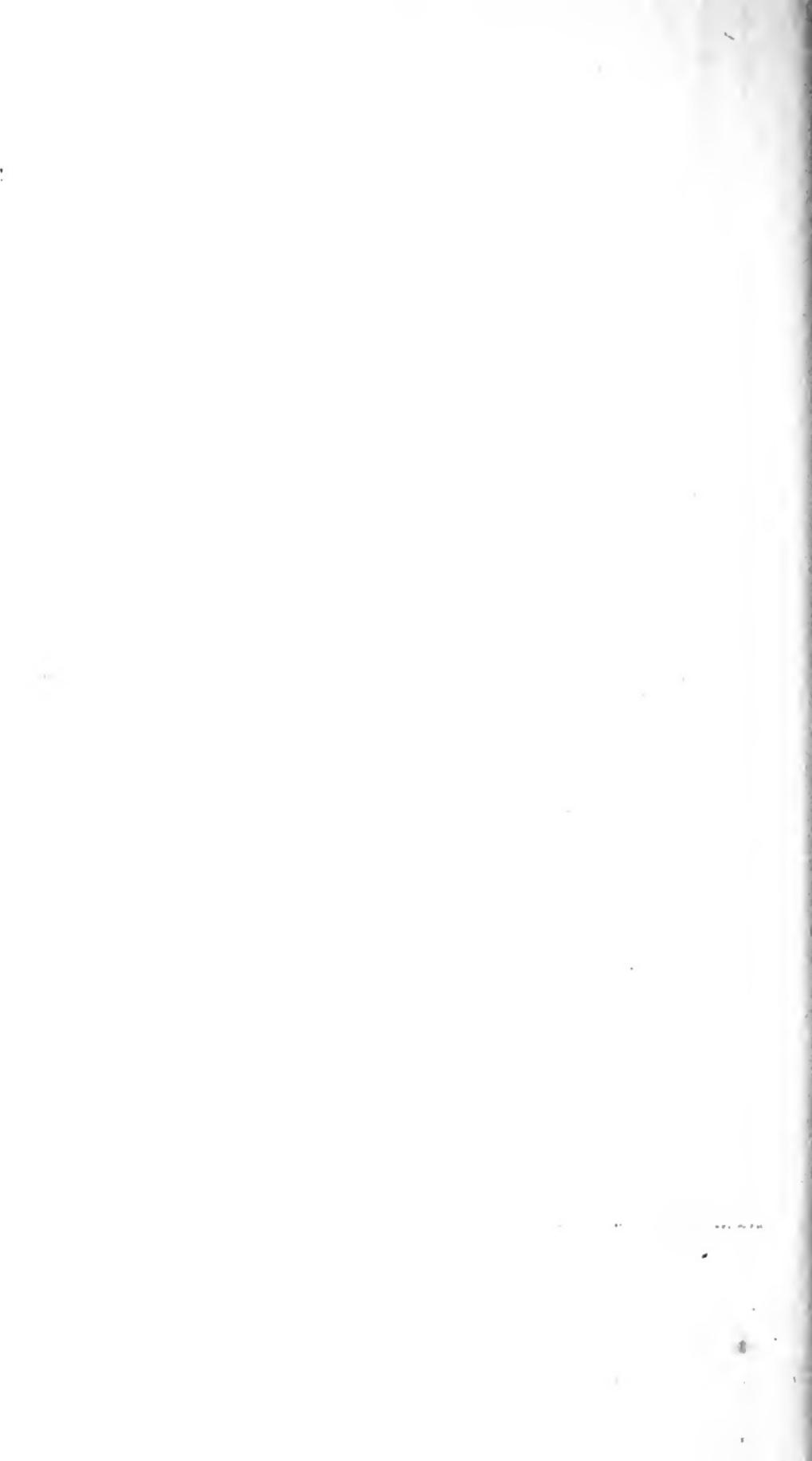
Details	Total	Well No. 1	Well No. 2	Well No. 3	Well No. 11	Well No. 16	Well No. 17
<b>INCOME (From Nov. 1, 1936 to Dec. 31, 1936)</b>							
Oil Sales .....	\$ 18,016.23	\$ 4,264.18	\$ 3,855.66	\$ 2,521.5*	\$ 316.59	\$ 4,561.79	\$ 2,496.51
Wet Gas Sales .....	2,675.87	547.41	268.13	557.89	589.59	257.27	455.58
Dry Gas Sales .....	89.44	8.23	5.70	9.82	10.73	32.28	22.68
Total.....	20,781.54	4,819.82	4,129.49	3,089.21	916.91	4,851.34	2,974.77
Less—Amounts due Participating Interests in Julian Wells, No. 16 and 17	3,260.94					2,050.67	1,210.27
Net Amount Oil and Gas Revenues.....	17,520.60	4,819.82	4,129.49	3,089.21	916.91	2,800.67	1,764.50
<b>EXPENSES</b>							
Well Operating Costs and Maintenance—Schedule D1.....	6,991.06	731.38	656.37	643.70	719.05	3,466.85	773.71
Field Overhead—Schedule D1 .....	1,908.00	318.00	318.00	318.00	318.00	318.00	318.00
General and Administrative Expense—Schedule D1.....	4,279.78	713.30	713.30	713.30	713.30	713.29	713.29
Taxes .....	1,123.61	187.88	187.70	187.19	186.39	187.52	186.93
Total Expenses .....	14,302.45	1,950.56	1,875.37	1,862.19	1,936.74	4,685.66	1,991.93
NET OPERATING PROFIT OR LOSS before deduction for depletion allowance .....	3,218.15	2,869.26	2,254.12	1,227.02	1,019.83	1,884.99	227.43
Depletion—27 1/2% of Net Amount of Oil and Gas Revenues *limited to 50% of net operating profit.....	3,074.57	1,325.45	1,135.61	613.51*			
OPERATING PROFIT (or Loss).....	\$ 143.58	\$ 1,543.81	\$ 1,118.51	\$ 612.51	\$ 1,019.83	\$ 1,884.99	\$ 227.43
<b>OTHER INCOME AND CREDITS TO PROFIT AND LOSS</b>							
Rental on Drilling Equipment .....	\$ 5,000.00						
Distributions received in 1936 from C. L. Olson and J. A. Smith, Co-Trustees of Julian Wells Nos. 1, 2, 3, 11, 16 and 17 from impounded funds, pursuant to Court Order made July 23, 1934 which order became effective on Oct. 28, 1936, issued in the matter of Julian vs. Schwartz, et al; Superior Court Case No. 315-345. Total amount received in 1936 as shown on Exhibit B, \$142,989.99, less depletion allowable and applicable thereto of \$69,213.03, or a net amount subject to income tax of .....	73,776.96						
Claim for interest accrued on note indebtedness relinquished in 1936.....	391.67✓						
Total.....	79,168.63						
<b>OTHER EXPENSE AND DEBITS TO PROFIT AND LOSS</b>							
Interest Paid .....	1,409.36✓						
Loss, account Royalties paid in 1930 to H. B. Flesher Well No. 16, repaid to J. A. Smith in 1936, pursuant to settlement made in accordance with judgment rendered in the matter of Julian vs. Schwartz.....	16,500.10✓						
Receivership Expenses—Schedule D 2 .....	17,574.68✓						
Total .....	35,484.14						
Net Other Income to Profit and Loss.....	43,684.49						
<b>NET TAXABLE INCOME FOR THE YEAR 1936</b>	\$ 43,828.07						

Geo. F. Meitner &amp; Co., Auditors and Accountants

[In longhand]: Part marked out omitted by stip.

[Endorsed]: U.S.B.T.A. Filed Oct. 4, 1941.





(Testimony of George F. Meitner.)

Mr. Burkhead: The petitioner rests.

The Member: The petitioner rests. What says the respondent?

Mr. Tonjes: The respondent rests.

In the matter of preparing briefs, might I state that the record in this case contains a very long stipulation and a very voluminous amount of documents, and I think perhaps that will be more helpful to the Board if I be permitted to file a reply brief to the Petitioner's opening brief. I am not at all sure as to how the Petitioner expects to correlate all of this mass of evidence with respect to the different issues.

Mr. Burkhead: I think in fairness that would be probably the correct way to handle it.

The Member: It seems to me that this is a case that lends itself to that. [160]

Very well. The petitioner will have until—is there any reason why you need more than 45 days?

Mr. Burkhead: That is after the receipt of the transcript?

The Member: No. From this date. We never can tell about the receipt of the transcript, and this reporter has a considerable load.

I will allow you until November 25th for the petitioner to brief. That will give you more than the 45 days, somewhat; and until December 25th for the respondent to answer, the petitioner to have until January 10, 1942, to reply.

The Clerk: December 25th is a legal holiday, being Christmas day.

(Testimony of George F. Meitner.)

The Member: Yes. I realize that. Make it then December 24th.

The Clerk: And January what?

The Member: January 10th. That will give them 16 days.

(Witness excused.)

Hearing Concluded.

[Endorsed]: U.S.B.T.A. Filed Oct. 21, 1941.

[161]

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[Title of Board and Cause.]

### FINDINGS OF FACT AND OPINION

Docket No. 105859. Promulgated August 20, 1942.

1. In 1930 petitioner was indemnified against any loss resulting from payment to the indemnitor of the proceeds of production of an oil well in accordance with existing agreements. The indemnitor died in 1934, leaving no estate. In 1936 the courts decided that an assignee of the indemnitor was entitled to the amount that had been paid to the indemnitor. Held, that the debt was ascertained to be worthless and charged off in 1936.

2. In 1936 petitioner canceled and credited to surplus the amount of \$7,000 representing salary accrued on its books in 1931 in favor of one of its officers. Petitioner sustained a net loss of about \$90,000 in 1931. Held, that the amount of salary

canceled in 1936 does not constitute taxable income to petitioner in that year.

3. Petitioner was in receivership during a portion of 1936. Held, that petitioner has failed to prove that it was insolvent at any time during that period within the meaning of section 14 (d) (2) of the Revenue Act of 1936.

4. Petitioner's oil and gas wells were in possession of and being operated by receivers and/or trustees from 1931 until November 1936, during which time the proceeds of production, less operating expenses chargeable to petitioner, were impounded pending judicial determination of the parties entitled thereto. Expenses of operation were deducted in determining the net amount payable to petitioner, part of which net amount was paid in 1936. Held, that the amount paid to petitioner in 1936, plus the amount of income which had been expended for operating expenses, constitutes gross income received from the property by petitioner in 1936 for depletion purposes.

5. In 1937 one of petitioner's wells ceased to produce and was transferred by quitclaim deed to one of its stockholders. Held, that petitioner may not deduct any amount as a loss, on account of failure to prove the cost of the property.

B. W. Burkhead, Esq., and Harold C. Morton, Esq., for the petitioner.

E. A. Tonjes, Esq., for the respondent.

This proceeding involves the redetermination of deficiencies in income tax for the years 1936 and 1937 in the respective amounts [180] of \$32,-

767.96 and \$15,816.89. The issues are (1) whether respondent erred in disallowing a bad debt deduction of \$16,500.10; (2) whether salary in the amount of \$7,000 accrued in 1931 and canceled in 1936 constitutes taxable income; (3) whether respondent erred in determining that petitioner was not insolvent during a period of receivership and therefore was subject to surtax on undistributed profits; (4) whether respondent erred in not allowing a greater amount as a deduction for depletion; and (5) whether petitioner sustained a deductible loss upon the abandonment of an oil well known as Well No. 16, and, if so, whether it was a capital loss or an ordinary loss. Other issues raised by the petitioner were abandoned at the hearing. The stipulation of facts filed in the proceeding is incorporated herein by reference as part of our findings of fact. Material portions thereof will be set forth in the findings of fact made from other evidence.

### FINDINGS OF FACT

Petitioner was organized in 1926 under the laws of California. It kept its books and filed its returns on the accrual basis. Petitioner's returns for the taxable years were filed with the collector for the sixth district of California.

In 1922 and 1923 C. C. Julian acquired several oil leases covering property in the Santa Fe Springs, California, field. The leases were assigned to the Citizens Trust & Savings Bank, Los Angeles, California, in trust, with direction to pay expenses of the trust and any balance to the trustor or such per-

son as he designated. The trustor had exclusive control of the leases as agent of any assignee of any interest therein. Pursuant to this plan C. C. Julian sold to the public fractional interests in wells to be drilled under the leases. Five oil and gas wells, known as Julian Wells Nos. 1, 2, 3, 11, and 12, were drilled with the proceeds of such sales.

In 1925 C. C. Julian entered into an agreement with D. R. Morrow and W. J. Barnhart by the terms of which the latter agreed to operate the wells for 50 percent of the production of the wells, exclusive of royalties. In 1927 the operating agreement was assigned to petitioner. In 1929 petitioner's compensation for operating the property was increased to 65 percent of the gross production, exclusive of royalties, out of which it was required to pay all operating expenses.

On March 9, 1928, the United Oil Well Supply Co. and others entered into an agreement, herein-after referred to as the United lease, leasing certain property to W. J. Barnhart. On September 28, 1928, W. J. Barnhart assigned to C. C. Julian such portion of the lease as related to certain property described in the lease, and another portion to petitioner. On the same day petitioner agreed in writing [181] with W. J. Barnhart to drill at its own expense a well on the property to productive sands below 5,000 feet. After payment of land-owners' royalty of 16 2/3 percent, if a well was drilled less than 5,000 feet, and 20 percent if drilled more than 5,000 feet, petitioner was entitled to receive \$100,000 out of the remaining production.

Thereafter the 83 1/3 per cent interest of the lessee was to be divided equally between petitioner and W. J. Barnhart after paying operating expenses, except that Barnhart's interest was not chargeable with more than \$250 per month while the well was flowing and \$500 per month while the well was being pumped. Petitioner also agreed on September 28, 1928, in another instrument, to pay C. C. Julian the sum of \$2,500 to be relieved of its obligation to drill a well deeper than 5,000 feet and to accept \$80,000, instead of \$100,000, for the drilling of such a well. Thereafter petitioner drilled a productive well on the property, known as Julian Well No. 16, to a depth of less than 5,000 feet.

On September 28, 1928, W. J. Barnhart assigned his interest in the operating agreement to Wm. M. Cady. On July 25, 1929, Wm. M. Cady assigned his interest to James B. Boyle as security. In acquiring the United lease and making the assignment to Wm. M. Cady, W. J. Barnhart was acting for C. C. Julian.

Well No. 16 produced prior to May 1930 sufficient oil and gas to pay petitioner out of 83 1/3 percent of the production the consideration of \$80,000 for drilling the well.

On May 15, 1930, C. C. Julian directed petitioner to pay to H. B. Flesher his one-half share of the proceeds of production of Well No. 16, this being the same interest W. J. Barnhart, acting for C. C. Julian, had assigned in writing to Wm. M. Cady on September 28, 1928.

On July 18, 1930, petitioner advised C. C. Julian by letter that on August 20, 1929, it had received a communication from James B. Boyle in which he claimed ownership of his interest in production of Well No. 16. On July 25, 1930, C. C. Julian advised petitioner that James B. Boyle had no interest in production of the well above 5,000 feet. The letter also contained the following:

The undersigned hereby agrees to fully protect and indemnify your company against any and all action or actions that may be brought against you by reason of you paying to me, or to my properly authorized agent, such sums of money to which I am entitled in accordance with existing agreements.

At various times thereafter in 1930 petitioner paid to H. B. Flesher the sum of \$16,500.10 out of 83 1/3 percent of the proceeds of production of Well No. 16.

On November 30, 1931, Wm. M. Cady assigned his interest in Well No. 16 to J. A. Smith. [182]

On September 28, 1928, W. J. Barnhart assigned to C. C. Julian the remainder of the United lease not involved in Well No. 16. Thereafter Well No. 17 was drilled on the premises. In 1930 petitioner undertook to place the well in condition to produce from the Meyer sand and if successful petitioner was to receive \$78,000, payable out of 41 2/3 percent of the production. Thereafter interests in the production of the well were: C. C. Julian, 41 2/3 percent; petitioner, 38 percent; and Santa Fe Springs Oil Co., 3 2/3 percent. As of January 1931

petitioner was in possession of and operating the well.

All of the wells hereinbefore described were purchased by R. L. Mack in an execution sale held to satisfy a judgment in the amount of \$10,925.98 obtained by one Garliepp against C. C. Julian in 1929. The purchaser conveyed his interest by deed to W. A. Schwartz, who thereupon claimed to be the owner of the wells except for the royalty interests.

In about January 1931 C. C. Julian instituted suit in the Superior Court of California to restrain Schwartz from taking possession of the wells. The holders of participating oil agreements in Wells Nos. 1, 2, 3, and 11 filed a cross-complaint in the action, wherein they claimed to be the owners of the interests assigned to them and also claimed that Wells Nos. 16 and 17 were wrongfully producing oil from Wells Nos. 1, 2, 3, and 11. On March 19, 1931, the court appointed two individuals as receivers to operate the wells under existing leases, sell the production of the property, paying therefrom royalties and expenses incident to the receivership and the operation of the wells, and retain other funds until further order of the court. In April 1931 the court discharged one of the receivers. On March 23, 1932, pursuant to a stipulation of all of the parties to the action, the court appointed two trustees to operate the wells, but continued the receivership for the purpose of carrying on the litigation. Judgment was entered in the case on September 7, 1933. The court held that petitioner and J. A. Smith were each entitled to an undivided one-

half interest in Well No. 16, subject to the terms of the lease entered into on March 9, 1928. The judgment was affirmed by the District Court of Appeal, August 28, 1936, 16 Cal. App. (2d) 310; 60 Pac. (2d) 887. The case was finally determined on October 28, 1936, upon the denial of a hearing by the Supreme Court of California. While the proceeding was pending the wells were in possession of and being operated by receivers and/or trustees, hereinafter referred to as trustees, under the direction of the court.

After the termination of the litigation, J. A. Smith, successor to Wm. M. Cady of the one-half interest in Well No. 16 originally held by C. C. Julian, presented a claim to petitioner for one-half of the funds accruing from production of Well No. 16 after the receipt by [183] petitioner of \$80,000 for drilling the well. The sum of \$16,500.10 was included in the amount paid by petitioner to H. B. Flesher upon the order of C. C. Julian. Petitioner conceded that the payments theretofore made to H. B. Flesher had been made in error and in 1936 paid the sum of \$16,500.10 to J. A. Smith in accordance with his demand. C. C. Julian died a suicide in China in 1934, leaving no estate.

Petitioner quitclaimed Well No. 16 to J. A. Smith on December 20, 1937, in accordance with a resolution of its board of directors held on that date.

The amount of \$16,500.10 was ascertained to be worthless and charged off in 1936.

On or about July 29, 1931, D. R. Morrow brought an action in the Superior Court of California

against petitioner, Guy L. Hardison, and W. J. Barnhart for an accounting of the affairs of petitioner; for an accounting to petitioner by W. J. Barnhart, general manager, and Guy L. Hardison, president of petitioner, for any and all profits, including secret profits, and for unlawful payments set forth in the complaint; contesting unlawful and excessive salaries paid to W. J. Barnhart and Guy L. Hardison, and for their removal as officers of petitioner; and for the appointment of a receiver to take charge of the affairs and assets of petitioner pendente lite. It was alleged in the complaint that W. J. Barnhart and Guy L. Hardison had caused to be paid to themselves and/or credited to them excessive salaries from about September 1928 in the amount of \$1,000 each per month. On the same day the court appointed Ralph S. Armour receiver for petitioner.

On July 29, 1931, there had been accrued on petitioner's books at the rate of \$1,000 per month to July 31, 1931, as "accrued payroll" payable to Guy L. Hardison, the sum of \$14,000. There was also recorded on petitioner's records as due to Guy L. Hardison on July 31, 1931, the sum of \$8,500, represented by two notes payable. This liability arose out of a purported sale by Guy L. Hardison to petitioner of certain oil well equipment in connection with Well No. 17.

The questions relating to the salary of \$14,000 accrued in favor of Guy L. Hardison and the notes in the amount of \$8,500 were not settled until December 11, 1936, when the board of directors of

petitioner authorized the payment of \$7,000 to him for salary to December 30, 1930. At that time Guy L. Hardison admitted that the salary accrued in his favor was excessive. The remainder of the salary, being for the first seven months of 1931 during which petitioner's affairs were in the hands of a receiver appointed in connection with the Julian v. Schwartz litigation, was not recognized or paid. Such salary was written off in 1936 as of 1931 and credited to surplus. [184]

The net income or net loss of petitioner each year from 1930 to 1935 was as follows:

	Net Income	Net Loss
1930 .....	\$3,175.54	.....
1931 .....	.....	\$90,116.67
1932 .....	.....	5,213.85
1933 .....	666.27	.....
1934 .....	.....	2,516.00
1935 .....	.....	6,063.64

In accordance with instructions of the court, the trustees kept a record of the income and operating expenses of each well. On July 23, 1934, the court issued an order directing the trustees to pay from funds in their possession certain amounts, including \$102,885.93 to petitioner. The court order was ineffective during the pendency of the appeal in the Julian v. Schwartz litigation. It became effective on October 28, 1936, when the case was finally determined and adjudicated. The amount of cash distributed to petitioner in 1936 pursuant to the order was \$112,000. In 1937 petitioner received the additional sum of \$121,037.94 from the trustees pursuant to a court order entered in February 1937.

The trustees paid the sum of \$17,852.13 to the receiver in 1936 for the account of petitioner.

In or about February 1937 the trustees made a report to the court of their records and accounts for the period December 1, 1930, to November 30, 1936. The accounting was approved by the court on October 19, 1937.

Ralph S. Armour, receiver, was never in complete charge or control of the assets of petitioner, as the oil wells at Santa Fe Springs were in control of and being operated by the trustees.

The balance sheet of the petitioner at the close of the years 1930 to 1934, inclusive, shows deficits as follows:

1930 .....	\$ 70,486.41
1931 .....	160,603.08
1932 .....	165,816.93
1933 .....	163,582.01
1934 .....	166,098.01

The balance sheet of petitioner at the close of 1935 was as follows:

ASSETS	
Supplies .....	\$ 594.09
Capital assets:	
Leasehold interests .....	\$224,251.92
Oil well machinery and equipment....	60,568.15
Intangible oil well costs.....	60,908.31
Automobiles and trucks .....	443.73
Office furniture and fixtures .....	811.50
	_____
	346,983.61
Less reserve for depreciation and depletion .....	99,979.87
	_____
	\$247,003.74

[185]

Patents .....	1,000.00
Good will .....	26,224.21
Capital stock issued for services and leases.....	219,120.50
Organization expense .....	42,488.53
Accounts receivable .....	35,507.19
 Total.....	 <hr/>
	571,938.26

## LIABILITIES

Notes payable .....	\$ 3,000.00
Accounts payable .....	17,267.70
Accrued expenses:	
Interest .....	1,396.67
Taxes .....	1,051.66
Pay roll .....	14,078.00
Due to stockholders .....	6,995.63
 Total liabilities .....	 43,789.66
Deferred credits .....	5,333.25
Capital stock .....	694,977.00
 Surplus (deficit) .....	 (172,161.65)
 Grand total .....	 571,938.26

The assets shown in the balance sheet as capital assets, except a well known as the Hartley Well (not carried as an asset after 1930), and office furniture and fixtures shown in the books after 1931 at a value of \$811.50, were not in the possession of petitioner from the time of the appointment of the receiver in 1931 until the final determination of the Julian v. Schwartz litigation in 1936, but were in the possession of the receiver in that litigation and were being claimed by Schwartz and the holders of participating oil agreements as asserted in the proceeding. The financial condition of petitioner remained about

the same from January 1, 1936, until the receipt in November 1936 of funds from the trustees.

The income and expenses of petitioner for 1936 were as follows:

#### INCOME

Oil and gas sales after November 1, less expenses.....	\$ 6,436.30
Rental on drilling equipment .....	5,000.00
Distributions from trustees .....	142,989.99
Claim for interest relinquished .....	391.67
	154,817.96

[186]

#### EXPENSES

Interest paid .....	\$ 1,409.36
Loss, erroneous payments to J. A. Smith	16,500.10
Receivership expenses .....	17,574.68
	\$ 35,484.14
Net income .....	119,333.82

None of the income impounded by the trustees in the Julian v. Schwartz litigation was considered as income to petitioner until released to it. In and after 1933, pursuant to a stipulation filed with the court in 1933, there was released to J. A. Smith for the account of petitioner proceeds of gas production of Wells Nos. 1, 2, 3, and 11 accruing to petitioner. At a hearing held in Washington, D. C., on August 13, 1937, these amounts were determined to have been constructively received by petitioner in 1933 and years subsequent thereto. There was deducted from such income depreciation on the tangible equipment of the wells and other tangible lease equipment which was then being used by the trustees. In addition to the depreciation so deducted, there was deducted and allowed business expenses

paid and accrued, including legal fees and receiver-ship expenses. The receivership expenses so allowed were allowed as deductions in and for the years for which they were definitely determined and approved by the court.

On November 12, 1936, Ralph S. Armour, receiver, filed with the court a final account and report showing that during the period of the receiver-ship he had incurred expenses, aggregating \$17,-852.12, as follows:

1931	Auditor's services .....	\$ 125.00	
	Appraisers' fees .....	300.00	
	Stationery .....	13.00	
	Notarial fee .....	.85	
	Advertising sale of equipment.....	12.00	
			\$ 450.85
1932	Telephone .....	73.57	
	Rent .....	302.50	
	Towel service .....	5.50	
	Auditors' serviees .....	1,750.00	
	Typewriter repairs .....	2.90	
	Loan by receiver to pay tele- phone bill .....	27.45	
	Insurance, Wells Nos. 16 and 17.....	108.53	
	Attorneys' fees .....	480.00	
			2,750.45
1933	Bond, Hartley Well No. 1.....	100.00	
			100.00
1934	Typewriter repairs .....	12.50	
			12.50
			[187]
1936	Attorney's fees .....	\$6,920.00	
	Receiver's bond .....	125.00	
	Office rent, phone, etc., pro rata.....	1,100.00	
	Receiver's fees .....	6,393.32	
			\$14,538.32
	Total.....		17,852.12

The court approved the account the day it was filed. In its order approving the account, the court said:

\* \* \* it appearing to the court that defendant, Barnhart-Morrow Consolidated, a corporation, is no longer insolvent by reason of its success in the litigation entitled: Julian v. Schwartz, No. 315-345, in this court, now finally determined on appeal, and that by reason of the termination of said litigation and the present solvency of said corporation, there is no longer any reason for the continuance of said receivership herein. \* \* \*

and directed that the receiver's expenses be paid out of the first moneys accruing and paid to petitioner.

The petitioner's share of the gross proceeds of production of Julian Wells Nos. 1, 2, 3, 11, 16, and 17 for the period December 1, 1930, to November 14, 1936, during which time the wells were in possession of and being operated by the trustees, was \$488,903.65. The total charges made against petitioner by the trustees for the operation of the wells during that period were \$223,352.83, leaving a balance of \$265,550.82 payable to petitioner. Of the net amount of impounded funds due petitioner, \$142,989.99 was paid to it in 1936, \$122,371.37 in 1937, and the balance of \$189.46 in subsequent years. The payment made in 1936 consisted of the following items: cash paid to Ralph S. Armour, receiver, for receivership expenses, \$17,852.13; cash to petitioner, \$112,000; depreciated cost of well equipment acquired by trustees and delivered to petitioner on November 14,

1936, \$7,992.90; compensation insurance, \$300; liabilities of petitioner paid by trustees, \$4,844.96.

The petitioner sustained an operating loss of \$3,258.78 in the operation of Well No. 16 in 1937 up to the time it ceased producing because of unknown damage to the well. Work of an undescribed nature on the well was necessary to ascertain the kind and extent of the damage and the cost of making repairs. J. A. Smith, the owner of the other one-half interest in the well, including its equipment, was not liable for more than \$250 per month for operating expenses of the well.

The terms of the United lease required petitioner to operate Well No. 16 even though in doing so it sustained a loss, and in the event that petitioner abandoned the well the lessor had the right to take possession thereof, including its equipment, and hold or operate the property at its own expense, free from any claim of the petitioner, subject, however, to a royalty of 8 1/3 percent to petitioner. In case the lessor did [188] not exercise the right to take over any abandoned well, petitioner was obligated to restore the premises to their original condition, including the plugging of the well in accordance with the laws of California. The cost of plugging a well is from \$5,000 to \$10,000. The well had some salvage value, probably \$2,000.

In December 1937 Harold G. Morton, an experienced oil operator and counsel, and a director and stockholder of petitioner, suggested to the board of directors of petitioner that the well be abandoned. At that time J. A. Smith held about 35 percent of

petitioner's stock and Harold G. Morton and another individual each held about 9 percent. The remainder of the stock was widely distributed. On December 20, 1937, the board of directors of petitioner adopted a resolution to surrender the well, and the premises pertaining thereto, to J. A. Smith and executed a quitclaim deed for the property in his favor.

Work done on the well immediately thereafter by J. A. Smith revealed that the liner thereof had crumpled. The damage was repaired at a cost of about \$800. The well sustained similar damage in 1936 and was repaired at a cost of about \$18,000.

The well was placed on production in January 1938, in which month it produced oil and gas of a value of about \$1,500. The gross production of the well was increased to \$2,550 in April 1938, and thereafter it decreased to \$700 or \$800 in October 1941.

## OPINION

### Bad Debt Issue

Disney: The respondent disallowed the item of \$16,500.10 as a bad debt deduction upon the ground that the debt was not ascertained to be worthless and charged off during the taxable year. The substance of respondent's argument upon brief is that the promise of C. C. Julian ceased to have any value in 1934, when he died leaving no estate, and that the "loss", if any, was sustained in that year.

It was stipulated that the amount was charged off in 1936, leaving for decision only the question of whether the debt was ascertained to be worthless.

in the same year. Both parties refer to the undertaking of C. C. Julian as a contract of indemnity and we will assume that it was such an agreement. Under it the indemnitor obligated himself to reimburse petitioner in the event petitioner was compelled to pay to another any amount paid to him or his agent under his claim of right to receive a portion of the proceeds of production of Well No. 16. This promise did not ripen into a claim against the indemnitor until 1936, when the courts of California decided that J. A. Smith was the owner of the interest under which C. C. Julian's nominee had received the sum in question. *Howell v. Commissioner*, 69 Fed. (2d) 447. Thus [189] there was not at any time prior to 1936 a debt against C. C. Julian to ascertain to be worthless. When it did come into existence, it was worthless and petitioner so ascertained it. Then, for the first time, there was a debt to collect, and if ascertained to be worthless, to charge off as uncollectible.

Respondent cites no authority for his statement that the obligation of C. C. Julian was discharged by his death. We find none. It was not a personal covenant, incapable of being performed by any other person. On the contrary, his obligation was one which survived him and for which his estate was liable. *Elliott v. Garvin*, 166 Fed. 278; *Brownfield v. Holland*, 63 Wash. 86; 114 Pac. 890. His estate was insolvent when the debt came into existence. We hold that the petitioner is entitled to deduct the amount in controversy as a debt ascertained to be worthless and charged off in 1936.

### Salary Issue

The respondent makes the general contention under the second issue that, where salary is accrued and deducted from income and the liability is satisfied in a subsequent year for less than its face amount, the difference between the liability and the amount for which it was satisfied constitutes taxable income. The rule laid down by the Board in and since Central Loan & Investment Co., 39 B.T.A. 981, has been that such an amount is not income unless the deduction made in a prior year served to offset taxable income. Estate of James N. Collins, 46, B.T.A. 765; Estate of Charles H. Robinson, 46 B.T.A. 943; Citizens State Bank, 46 B.T.A. 964.

Here the petitioner had a net loss in 1931 of \$90,116.67 and no contention is made that the compensation canceled in 1936 was not deducted in arriving at the net loss. Accordingly we sustain the petitioner on this issue.

### Insolvency Issue

In his determination of the deficiency for 1936 respondent held that petitioner was not insolvent at any time during the period of its receivership in that year and therefore was not exempt from surtax on \$89,476.51 of undistributed net profits under the provisions of section 14 (d) (2) of the Revenue Act of 1936.<sup>1</sup> [190]

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\*      \*      \*      \*      \*      \*      \*

<sup>1</sup>Sec. 14. Surtax on undistributed profits.

(d) Exemption From Surtax. The following cor-

The difference between the parties is whether petitioner was insolvent in 1936 during the period of receivership. They agree that if it was insolvent at any time during that period the statute exempts petitioner from surtax.

In Artesian Water Co., 43 B.T.A. 408, we said that the word "insolvent" as used in section 14, supra, "was intended by Congress to carry the meaning used" by the Supreme Court in Dutcher v. Wright, 94 U.S. 553. In that case the Court said that "Insolvency, in the sense of the Bankrupt Act, means that the party whose business affairs are in question is unable to pay his debts as they become due, in the ordinary course of his daily transactions." We thought this was evidenced by the Senate Finance Committee Report on the provision, in which the committee said:

The Finance Committee Bill also avoids the possibility of tax avoidance by collusive Receiverships by limiting the provision to cases in which the corporation is in bankruptcy under the Federal bankruptcy laws, and to cases in which it is insolvent, i.e., its liabilities are in excess of its assets or it is unable to pay the claims of creditors as they mature—and in receivership in Federal or State Courts.

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porations shall not be subject to the surtax imposed by this section:

\* \* \* \* \*

(2) Domestic corporations which for any portion of the taxable year are in bankruptcy under the laws of the United States, or are insolvent and in receivership in any court of the United States or of any State, Territory, or the District of Columbia.

In holding that the petitioner did not come within the exemption provided by the statute, we referred to proof that during the taxable year its assets were about ten times its liabilities, exclusive of capital stock and surplus, and that it had made payments on some of its obligations.

Regulations 94, promulgated for the Revenue Act of 1936, does not define the meaning of insolvent. See art. 14-1. Article 13-4 of Regulations 101, Revenue Act of 1938, defines the term insolvent as meaning "insolvency in the sense of excess of liabilities over assets and in the sense of inability to meet obligations as they mature."

Regulations 103, applicable to the Internal Revenue Code, defines the term insolvent as meaning "insolvency either in the sense of excess of liabilities over assets or in the sense of inability to meet obligations as they mature." Sec. 19. 13-4. A definition that "insolvency is established if liabilities exceed assets or if the debtor corporation is unable to meet its obligations" was agreed upon by the parties in *United States v. Anderson*, 119 Fed. (2d) 343. In that case the court said that in determining insolvency "the court should allow for reasonable use of the debtor's credit."

The United States Circuit Court of Appeals, in reversing Artesian Water Co., *supra*, said that as the taxpayer's assets exceeded its liabilities and it was not, therefore, insolvent in a bankrupt sense, solvency or insolvency turned upon whether "the taxpayer was able to meet its obligations as they matured, in the usual course of trade or business."

125 Fed. (2d) 17. It decided that the taxpayer was unable to meet its [191] obligations, "either from its current assets or with 'the reasonable use of the debtor's credit' (United States v. Anderson Co., *supra.*)"

We think a corporation is insolvent within the meaning of section 14 (d) (2), *supra*, if at any time during receivership it is unable to meet its obligations as they mature in the ordinary course of business, with a reasonable use of its credit.

All of petitioner's oil and gas property was in the possession and control of trustees appointed by the court in the Julian v. Schwartz litigation. The remaining assets were in the possession and control of a receiver appointed in the litigation instituted by D. R. Morrow in 1931. The balance sheets of petitioner at the close of the years 1932, 1933, 1934, and 1935 reflect, exclusive of the oil and gas properties, no cash on hand. Other assets on which something might have been realized consisted of supplies in the amount of \$594.09, patents \$1,000, stock issued for service and leases \$219,120.50, and accounts receivable of \$35,507.19. Its liabilities, consisting of notes and accounts payable, accrued expenses and amounts due stockholders, were \$55,-611.12, \$43,580.75, \$43,111.14, and \$43,789.66, respectively, at the close of 1932, 1933, 1934, and 1935. The balance sheets of petitioner as of the termination of the receivership and at the close of 1936 were not introduced in evidence. Testimony, however, established that there were no substantial changes before the termination of the receivership in 1936.

Though the final accounting of the receiver disclosed obligations incurred as early as 1931, the record does not disclose whether any of the debts shown by the balance sheets, except salary accrued in 1931 in favor of Guy L. Hardison in the amount of \$14,000, but which was involved in the litigation instituted by D. R. Morrow in 1931, matured during the receivership. No evidence was offered as to the arrangements made, if any, with the creditors for payment of these debts.

The burden was on petitioner to establish its insolvency and any deficiency of proof must operate against it. No attempt was made to show inability to meet maturing debts by a reasonable use of credit. It is true that the oil and gas properties were in the possession and control of the trustees and for that reason could not have been used by the receiver as collateral for a loan, but he had under his control stock of a book value of about \$220,000. Nothing of record is opposed to the idea that this stock could have been used as security for a loan or sold to pay debts. Neither does it appear that an application was ever made to the court for permission to sell receiver's certificates or otherwise raise funds to meet matured obligations.

We do not regard as helpful to petitioner the statement appearing in the court order of November 12, 1936, that petitioner was no longer [192] insolvent by reason of the litigation. It does not appear that the court ever had before it the question of solvency or insolvency of petitioner. Neither does it appear that any of the parties in interest ever al-

leged such a fact in pleadings before the court. On the contrary, the complaint filed by D. R. Morrow, which resulted in the appointment of the receiver, alleged, among other things, that the corporation had been in a prosperous condition and was then operating at a profit, but that the profits were being diverted from the stockholders and petitioner. The receiver does not appear to have received any funds until the latter part of 1936, when his expenses were paid out of receipts from the trustees, but inability to pay due to impounding of assets in a receivership, not based upon grounds of insolvency, is not proof of insolvency in the sense of inability to meet maturing debts. The receivership of itself does not prove insolvency.

The petitioner has failed to prove that it was insolvent at any time during the period of receivership in 1936. Accordingly we sustain the respondent on this issue.

#### Depletion Issue

In his determination of the deficiency for 1936 respondent allowed depletion on \$122,371.37, representing the amount received by petitioner in cash and credits in that year out of the funds impounded by the trustees in the Julian v. Schwartz litigation. He contends here that that amount constitutes petitioner's gross income and net income during the taxable year from the operation of the wells by the trustees. Petitioner contends that it is entitled to depletion on not only the \$122,371.37 thus received, but on the additional amount of \$223,352.83, representing expenses incurred by the trustees in the

operation of the properties, all of which was chargeable to and charged to petitioner. Thus petitioner seeks depletion on \$366,342.82 and respondent asks us to restrict it to the net amount. The facts are not in dispute. Depletion on the production of the wells in 1936 after petitioner acquired possession of the wells and in 1937 is not in controversy.

Petitioner insists that its economic interest in the production of all of the wells was \$488,903.65 and that it could not actually or constructively receive the net economic interest of \$265,550.82 (\$488,903.65 less operating expenses of \$223,352.83) without constructively receiving the \$223,352.83 charged to it for operating expenses.

The parties agree that under the rule of *North American Oil Consolidated v. Burnet*, 286 U. S. 417, no part of the proceeds of production constituted taxable income to petitioner until received by it. They also reached an agreement in 1937 that no income tax liability would be assessed against the trustees for the years 1931 to 1936, but [193] that the recipients of the proceeds of production would be liable for income taxes in the year or years in which the funds were distributed.

We think the question is controlled by *Crews v. Commissioner*, 89 Fed. (2d) 412, affirming, on the point involved herein, 33 B.T.A. 441.<sup>2</sup> In that case in 1922, while certain litigation relating to failure to drill offset wells was pending, the lessors of oil prop-

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<sup>2</sup>For a complete history of the proceeding see also 30 B.T.A. 615; 31 B.T.A. 187; 37 B.T.A. 387; 108 Fed. (2d) 712; 120 Fed. (2d) 749; 33 B.T.A. 36.

erty entered the undeveloped section of the leased land and began development thereof. The Sinclair Oil & Gas Co., operator of the developed portion of the property as assignee of the lease, served notice that it claimed a right to such production as might be obtained by the lessors. To provide an outlet for their production, the lessors entered into an escrow agreement under the terms of which seven-eighths of the proceeds of production was to be deposited in escrow in a bank, subject to payment to the proper parties in interest when the litigation was settled, the escrow agent to pay to the lessors in the meantime such sums out of the escrow funds as were necessary for them to use in further developing the land. The litigation was settled in October 1930. Prior thereto there was expended out of the escrow funds the sum of \$849,544.37 for drilling, equipping and operating wells and for miscellaneous purposes incident to the production of oil and gas. While this arrangement was in effect the lessors produced from the property entered by them oil and gas in the amount of \$1,462,504.02. Aside from the moneys expended for development and operating purposes, no part of the escrow funds was actually paid to the lessors, due, among other things, to misappropriation of funds by officials of the bank and worthlessness of an indemnity agreement executed in connection with the matter and the giving of a release by the lessors in favor of the bank.

The question involved in the proceeding was the amount of depletion to which the lessors were entitled, in connection with which it was necessary to

determine the amount of gross income from the property. We held that gross income from the property was \$1,462,504.02 less \$514,000 representing bonds purchased with escrow funds by the bank, no part of which, however, was ever received by the lessors, plus \$355,000 received from Sinclair in 1930, the taxable year, in settlement of the litigation, a total of \$1,303,504.02. Upon appeal the court held that the gross income from the property was \$1,204,544.37, being \$849,544.37 plus \$355,000. Subsequent consideration of the proceeding by this Board and the Circuit Court of Appeals did not in any wise alter the conclusion thus reached that upon settlement of the litigation and the termination of the escrow agreement in 1930, the taxable year, the amount of \$849,544.37 paid out of production for development and operating purposes constituted gross income.

In that case, as already indicated, there was nothing in the escrow fund in 1930 to pay over to the lessors. Hence none of the proceeds of production were actually received, except for the \$849,544.37 expended for development and operating purposes. Here the proceeds of production during the pendency of the Julian v. Schwartz litigation were in excess of operating expenses paid by the trustees out of production and upon the final termination of the litigation in 1936 only a part of the net proceeds was paid to petitioner. We do not think this point of difference in the facts of the two proceedings requires a different conclusion. The expenditures were made out of production of oil and

gas for the benefit of petitioner. Under *North American Oil Consolidated v. Burnet*, 286 U. S. 417, we must consider the petitioner as having received no income until its right thereto was determined and receivership terminated, which was in 1936, and that the fact that the money was earned in previous years does not control; and the Crews case applies the principle there enunciated squarely to gross income, arising from oil production in years earlier than the year of receipt, for the purpose of computing depletion. This is consistent with the agreement of the parties that taxation would fall in the years when the funds were distributed. We hold the item of \$223,352.83 to be gross income in 1936 from the property and that the Commissioner erred in refusing to allow petitioner depletion thereon. Depletion will accordingly be recomputed on the basis of \$488,903.65 as the gross income from the property, the amount of depletion on the entire property for the year 1936 not to exceed, however, 50 percent of the net income from the property. There appears to be no difference of opinion between the parties on the facts necessary to compute the net income from the property.

#### Loss, Well No. 16, Issue

The respondent is contesting the allowance of petitioner's claim for a loss of \$43,151.96 upon the relinquishment in 1937 to J. A. Smith of its one-half interest in Well No. 16 upon the ground that the petitioner has failed to prove the cost or other basis of the property. Petitioner relies upon its Exhibit No. 57 to establish the amount of its loss.

This exhibit is a statement prepared from petitioner's books showing entries made therein for the cost of tangible well equipment, less depreciation, and intangible drilling cost, less depletion and depreciation on drilling equipment.

In his determination of the deficiency the respondent disallowed a loss of \$38,984.02 claimed by petitioner in its return upon the ground that the alleged loss did not fall within the provisions of [195] section 23 of the Revenue Act of 1936. During the course of the hearing in this proceeding respondent's counsel announced that the amount of the loss was in dispute. Exhibit No. 57 was offered by the petitioner "for the purpose of showing the method and the manner in which petitioner arrived at the figure of \$43,151.96 \* \* \*" and not for the purpose of showing that it is evidence of the fact that they did sustain that, but to show how we arrived at that figure, to show our method of computing." Counsel for the respondent objected to the introduction of the document in evidence "in the form offered as being immaterial." The objection was overruled and the exhibit was admitted in evidence "for the purpose stated by counsel."

The method employed in determining the amount of a loss is not in every instance proof of cost or other basis. It does not prove the cost in this proceeding. Respondent never agreed that petitioner's books reflected actual cost of the well. Petitioner deducted from the book costs of tangible equipment a total of \$17,889.48 for depreciation. Whether this amount represents the "amount allowed (but not

less than the amount allowable)" within the meaning of section 113 (b) (1) (B) of the Revenue Act of 1936 does not appear. Depreciation in the amount of \$3,604.26 on drilling equipment was included in a total of \$74,167.31 for intangible drilling costs. No evidence was offered to prove whether the item of \$3,604.26 represents the correct figure for depreciation and the record is void of any evidence to show that these intangible drilling costs were not deducted as ordinary and necessary business expense in the year in which they were incurred, as permitted by article 243, Regulations 74. The balance sheet as of the close of 1935 has an item of \$60,568.15 for intangible drilling costs of the well, but that does not, without more, prove that petitioner has not had tax benefit from the expenditure. No allowance was made by petitioner in the computation for the salvage value of the well.

The evidence of record fails to prove the amount of any loss sustained by petitioner in connection with the transfer of its interest in Well No. 16. Accordingly we sustain the respondent on this issue.

Decision will be entered under Rule 50. [196]

[Title of Board and Cause.]

MOTION AND APPLICATION FOR RECONSIDERATION OF DECISION OR REHEARING AND FOR ADDITIONAL FINDINGS

Barnhart-Morrow Consolidated, Petitioner herein, now respectively moves the Board for a reconsideration of the decision in this matter promulgated August 20, 1942, or for a rehearing of this matter, and that additional findings be made.

This Motion and Application is upon the grounds that the decision with respect to two of the issues here involved inadvertently misconceives the purport of the testimony in the record and inadvertently fails to give consideration to stipulated facts in the record and is contrary [198] to stipulated facts and the undisputed testimony with respect to such two issues. Said grounds of this Motion and Application will be more particularly detailed in the consideration herein of each of the two issues as to which the decision is by Petitioner claimed to be so erroneous.

Further, the findings on one of the other issues are incomplete with respect to the income of Petitioner as to each of the wells for the years 1936 and 1937, and additional findings are now requested to be made to cover said matter, as hereinafter more fully set forth.

PRELIMINARY STATEMENT

This matter was submitted largely on a lengthy Stipulation of Facts, which Stipulation of Facts

incorporated a total of fifty-four (54) exhibits. The Stipulation of Facts was supplemented by oral testimony and additional exhibits. There were five issues submitted for determination, three of which issues were determined in favor of Petitioner. Two of the issues were determined favoring the contentions of the Respondent and against the contentions of Petitioner. As to such latter two issues, we sincerely urge that the decision is contrary to the undisputed proof, both in the Stipulation of Facts and the oral testimony. The Stipulation of Facts is incorporated in the findings, and certain of the stipulated facts being contrary to facts recited in the Opinion, we present this Motion and Application. [199]

#### LOSS, WELL No. 16, ISSUE

With respect to the Loss, Well No. 16, Issue, the Opinion determines the issue against Petitioner, stating that the evidence fails to prove the amount of any loss sustained by Petitioner in that the Petitioner failed to prove the cost of Well No. 16.

The Opinion then refers to Exhibit No. 57 and states that said exhibit was offered by Petitioner:

“ \* \* \* for the purpose of showing the method and the manner in which petitioner arrived at the figure of \$43,151.96 \* \* \* and not for the purpose of showing that it is evidence of the fact that they did sustain that, but to show how we arrived at that figure, to show our method of computing.”

(Opinion, page 17).

The objection of materiality to this exhibit was overruled and it was admitted:

“ \* \* \* for the purpose stated by counsel.”

The Opinion then states:

“The method employed in determining the amount of a loss is not in every instance proof of cost or other basis. It does not prove the cost in this proceeding.”

The undisputed proof in the case shows that Exhibit No. 57 gives the detail of the cost of Well No. 16, as we will shortly hereinafter show; however, another exhibit, part [200] of the stipulated facts, to wit, Exhibit No. 51, sets forth the cost of Well No. 16, both tangible and intangible. Reference to said Exhibit No. 51, which by Paragraph XXXVI of the Stipulation of Facts is stipulated to be the Balance Sheet of Petitioner as per its books for the years 1930 to 1935, shows under the caption “Capital Assets” the name of the account on the books of Petitioner as “Oil Well Machinery and Equipment”, and immediately below it, Santa Fe Springs Wells Nos. 1, 2, 3, 11, 16 and 17, and represents all of the tangible equipment costs with respect to those wells. Under the account name “Intangible Oil Well Costs” (a sub-head under “Capital Assets”) appearing on said Exhibit No. 51, there immediately follows below it “Santa Fe Springs Well No. 16”, showing that the Petitioner had capitalized on its books the intangible drilling costs of Well No. 16, which at December 31, 1935 amounted to \$60,908.31. (The Opinion herein er-

roneously states that such intangible costs were \$60,568.15, which amount in fact represents the tangible equipment costs of Wells Nos. 1, 2, 3, 11, 16 and 17.) The difference in the Intangible Development Cost of Well No. 16 as at December 31, 1935 of \$60,908.31 (Exhibit No. 51) and the amount of intangible cost as at December 20, 1937 of \$74,-167.31, as set forth on Exhibit No. 57, represents the intangible costs of reconditioning Well No. 16 when the casing and tubing collapsed in March, 1937. Note then the uncontradicted proof [201] was that approximately \$14,000 of the intangible expense was in the year 1937, the year here under review.

The Opinion herein has referred to the intangible expense, stating:

“ \* \* \* the record is devoid of any evidence to show that these intangible drilling costs were not deducted as ordinary and necessary business expense in the year in which they were incurred, as permitted by article 243, Regulations 74.”

This overlooks the fact that the stipulated Exhibit No. 51 shows that the intangible drilling costs were not charged off as expense, but capitalized. Said Exhibit No. 51 shows the intangible drilling costs being carried on the books of the Petitioner as a capital asset.

In this proceeding Respondent has not claimed at any time that Petitioner had expensed its intangible drilling costs or in any manner had a tax benefit from such expenditures. This, of course, is

for the very obvious reason that Respondent had stipulated that Exhibit No. 51 was a correct balance sheet and it shows the intangibles on this well to have been capitalized. Respondent also was fully aware, through audits and investigation of Petitioner's tax returns, that Petitioner has never expensed such items, and in prior income tax returns filed by Petitioner with Respondent no deduction for intangibles had been taken as expense items from the time the well was drilled until the same was abandoned, and it was only upon the [202] abandonment loss in 1937 that the amount of such intangibles was claimed as a loss, that being the very item involved in this proceeding. Also, as stated, approximately \$14,000 of this intangible expense was in the year 1937, the year under review.

With respect to Exhibit No. 57, the undisputed testimony of Mr. Geo. F. Meitner, a Certified Public Accountant, was that the figures thereon came from the original books and records of Petitioner. Such original books and records of Petitioner were actually present at the hearing before the Board; being large and bulky, they, of course, were not introduced in evidence, but instead figures were taken therefrom placed in a schedule and offered in evidence. Mr. Meitner, after testifying as to his familiarity with the books and records of Petitioner and the fact that the originals were in Court, testified:

"Q. (By Mr. Burkhead.) May I ask the witness to point out to me the statement which

I think you have prepared showing that \$42,-000 item that is claimed as a loss on that well?

A. On the same statement?

(Referring to Well No. 16)

Q. Can you state briefly how the figure of \$43,151.96 claimed as a loss on Well 16 was arrived at and established?

Mr. Tonjes: Claimed as a loss on what?

Mr. Burkhead: On the abandonment of Well No. 16. [203]

Mr. Tonjes: In the petition?

Mr. Burkhead: That is right.

The Witness: Well, from the books of the corporation I prepared this agreement—this exhibit, showing tangible well equipment of \$26,890.37, less the cost of casing and tubing collapse at March, 1937, of \$5,959.12, making the net original return for well equipment cost as set up on the records \$20,931.25.

Q. (By Mr. Burkhead.) Maybe I can shorten this. Is this tabulation that I hand you now, does it reflect the figures and the manner in which you arrived at that figure, total figure of \$43,151.96? A. It does.

Q. And the figures appearing on this statement, did you take those from the books of Barnhart-Morrow Consolidated?

A. I did."

Counsel for Respondent then cross-examined Mr. Meitner on this figure of \$43,151.96 he claimed loss on this transaction, as follows:

"Mr. Tonjes: Might I ask the witness a question or two?

Mr. Burkhead: Yes.

Mr. Tonjes: Mr. Meitner, in determining this figure of \$43,151.96, you obtain all these figures from the books of Barnhart-Morrow?

The Witness: Yes, I believe I have got all the figures set up there at the time I made the audit.

Mr. Tonjes: Did some of the figures come from the books of the trustee?

The Witness: No, they didn't.

Mr. Tonjes: You state that there has been claimed a deduction for depletion on December 31, 1935, in the amount of \$28,472.01. Where did you get that figure? [204]

The Witness: That is on the books of the corporation.

Mr. Tonjes: What does it represent?

The Witness: It is depletion that had been accrued on production in prior years up to December 31, 1935, referring to that \$28,472.01.

Mr. Tonjes: That depletion represents depletion during the period in which the trustees operated the wells?

The Witness: No. That practically represents the depletion up to the time that the wells were taken over by the trustees. In other words, it is in the early years of production of Well No. 16.

Mr. Tonjes: That is depletion sustained prior to the time the trustees took over the operation of the wells?

The Witness: That is correct.

Mr. Tonjes: And do you know whether or not that corresponds with the depletion figure deducted from the income tax return for this corresponding period?

The Witness: Yes, I do.

Mr. Tonjes: Did you check that?

The Witness: Yes, I did. In other words, in my conference back in Washington it may be that this might have a little depletion with respect to gas production of well—no, because Well 16 wasn't involved in that. This is all prior to the time the receivers took over the operation of that well.

Mr. Tonjes: And the two figures immediately following, depletion on Olson and Smith distribution of 1936 of 9400 and eight thousand odd dollars, how did you ascertain that figure? [205]

The Witness: Those were calculated by me on the amount of gross proceeds of the oil which had been credited the Barnhart-Morrow by Olson and Smith in the report that I prepared for that receivership.

Mr. Tonjes: In other words, that represents depletion?

The Witness: As I calculated it.

Mr. Tonjes: For a period during which Barnhart-Morrow did operate the wells?

The Witness: That is right.

Mr. Tonjes: I have no further questions."

Mr. Tonjes thus established that all the depletion to be credited on the intangible drilling cost on this well had been computed and appeared on the records of the Petitioner. Mr. Tonjes, of course, knew that Petitioner had not expensed intangibles or this examination would have been entirely different. Mr. Tonjes was very properly making sure that the total depletion to be deducted from the intangible cost was set forth on Exhibit No. 57.

The Exhibit No. 57 to which Mr. Meitner had been referring was then offered in evidence, counsel stating that it was offered by Petitioner:

"\* \* \* for the purpose of showing the method and the manner in which petitioner arrived at the figure of \$43,151.96 \* \* \* and not for the purpose of showing that it is evidence of the fact that they did sustain that, but to show how we arrived at that figure, to show our method of computing."

Counsel for the Respondent objected to the introduction of the [206] document in evidence:

"\* \* \* in the form offered as being immaterial."

The objection was overruled and the exhibit was admitted in evidence:

"\* \* \* for the purpose stated by counsel.",

such purpose being, as stated by counsel, to show how Petitioner arrived at the \$43,151.96 (the amount of the loss claimed). Said exhibit showed

that it was arrived at by taking the tangible well equipment cost, less certain theretofore allowed depreciation and other proper deductions, and the intangible drilling cost (which was detailed as to items), less depletion. It detailed the cost.

Exhibit No. 57 shows that casing and tubing had collapsed in said well as early as March, 1937, and Mr. Meitner testified to such collapse of casing and tubing. The cost of the casing and tubing which collapsed was \$5,959.12, and against which there had been provided for depreciation up to the time of the collapse of the tubing and casing in March of 1937, the sum of \$4,877.58, as shown on said Exhibit No. 57, leaving a loss sustained on the casing and tubing collapse of \$1,081.54. This loss was allowed by the Respondent as a deduction from income in the year 1937 as set forth on Exhibit No. 61 under the caption of "Expenses"—"Loss on Tubing Collapse" \$1,081.54 and the amount was extended under Well [207] No. 16 in said Exhibit No. 61. Depreciation was allowed by the Respondent on tangible oil well equipment on Well No. 16 for the year 1937, which depreciation allowance is reflected in Well Operating Costs and Maintenance, Exhibit No. 61. The depreciation so allowed, together with the depreciation allowed in prior years, was used in determining the loss sustained on the tubing collapse of \$1,081.54, and the loss sustained on the tangible equipment when the well was abandoned by the Petitioner in December 1937, and is as set forth in Exhibit No. 57.

Mr. Meitner testified with respect to depletion and to the effect that the sum of \$28,472.01 Depletion Reserve as at December 31, 1936, as set forth on Exhibit No. 57 was accrued on the books and on the production of Well No. 16 up to the time that the well was taken over by the trustees in the matter of Julian vs. Schwartz. Mr. Meitner further testified with respect to the depletion on Olson and Smith distributions in the years 1936 and 1937 and that the amounts of depletion of \$9,407.29 and \$8,050.80 for those years, 1936 and 1937, were "as I calculated it."

The amount of the allowance for depletion on the distributions received from Olson and Smith was one of the issues in this proceeding, and to the extent that the allowance for depletion as shown on the books of Petitioner and by Mr. Meitner placed on Exhibit No. 57, might be at variance [208] with the allowance for depletion determined in this proceeding for the years 1936 and 1937. As respects Well No. 16, the extent of the loss on abandonment of Well No. 16, as set forth on Exhibit No. 57, would be required to be adjusted. Actually, now that we have the decision on the depletion issue, the variance between the figures on Exhibit No. 57 and the decision herein actually involves only the sum of \$387.67.

The important thing about Exhibit No. 57 is that it sets forth the detail of the items of cost to Petitioner of Well No. 16, less the appropriate deductions. This was the "method" of establishing the

loss, that is, to show the cost to Petitioner of Well No. 16. The basis of the loss with respect to Well No. 16 on abandonment and quitclaim could only be the cost less deductions, such as were set forth and any possible salvage.

Further testimony as to the cost and basis of Petitioner's loss is the following testimony of Mr. Meitner which was unquestioned and undisputed in the record (Record, p. 60):

"Q. (By Mr. Burkhead): Mr. Meitner, will you state how the mechanics from a bookkeeping standpoint of this \$43,151.96 (loss) was reflected by you on the books of the corporation.

A. Well, an entry was made charging off the equity remaining balanced, the difference between the cost value of the tangible equipment and the intangible drilling cost of the well less the reserve for depreciation on the tangible equipment, and the depletion reserve on the intangible equipment to arrive at, charged off as a loss to profit and loss on the company's records.

Q. In the year 1937?

A. In the year 1937." [209]

The Opinion states:

"No allowance was made by petitioner in the computation for the salvage value of the well."

However, as the Opinion itself points out, the undisputed testimony was that the salvage amounted

to "probably \$2,000" and it was best to abandon such salvage rather than incur the expense of plugging the well, which would clearly exceed such salvage value. (Opinion, p. 10.)

After counsel for Petitioner and counsel for Respondent had worked out the long Stipulation of Facts herein, the Board Member asked counsel for a statement of position on each issue. On this Well 16 Issue counsel for Respondent did not question the correctness of the cost of the well as on the books of petitioner and presently appearing on the prepared schedules, but questioned this item on other grounds, the full statement of counsel for Respondent being as follows (Record, page 10):

"Another issue is the abandonment of Well No. 16. That, of course, is perhaps largely factual. We have stipulated that the property was quitclaimed, but there again it was quitclaimed to a stockholder of the organization, Mr. Smith again, and apparently there was no effort made to salvage any property or anything of that sort. It was just given to him, and respondent submits that under the circumstances, why, there is no deductible loss resulting, and if there is a loss at all, it is a capital loss and the capital limitation applies.

The Member: It was claimed as an ordinary loss?

Mr. Tonjes: I think it was, yes, your Honor." [210]

The evidence established the loss and disposed of the matters referred to by Mr. Tonjes.

The pleadings in this matter (Petition and Answer) establish that Exhibit A to the Petition is Respondent's notice of deficiency as to Petitioner's years 1936 and 1937, which deficiency gave rise to this proceeding. An examination of that document (Notice of Deficiency) shows at page 8 thereof, that the loss on Well 16 was disallowed "as not falling within the provisions of Section 23 of the Revenue Act of 1936." That section refers to Deductions from Gross Income. An examination of the deficiency notice shows that it was only written after a thorough and exhaustive examination of the records and documents pertaining to the various matters affecting the income and expense of Petitioner for the years 1936 and 1937. Nothing is therein stated about the failure of Petitioner to show the cost of Well 16, or Petitioner's inability to establish a basis for the amount of the loss on abandonment of Well 16. Had such been the case Respondent would have rejected the loss on that ground. [211]

### INSOLVENCY ISSUE

The other issue with respect to which Petitioner believes that the Opinion has misconstrued and overlooked undisputed evidence is that for convenience called the "Insolvency Issue".

With respect to this issue, the Opinion was against the Petitioner upon the ground that "the Petitioner has failed to prove that it was insolvent at any time during the receivership in 1936".

The opinion states that

"We think a corporation is insolvent within the meaning of section 14 (d) (2), Supra, if at any time during receivership it is unable to meet its obligations as they mature in the ordinary course of business, with a reasonable use of its credit."

"All of petitioner's oil and gas property was in the possession and control of trustees appointed by the court in the Julian v. Schwartz litigation. The remaining assets were in the possession and control of a receiver appointed in the litigation instituted by D. R. Morrow in 1931. The balance sheets of petitioner at the close of the years 1932, 1933, 1934, and 1935 reflect, exclusive of the oil and gas properties, no cash on hand. Other assets on which something might have been realized consisted of supplies in the amount of \$594.09, patents \$1,000, stock issued for services and leases \$219,120.50, and accounts receivable of \$35,507.19."

Apparently, the decision of insolvency hinged upon Petitioner meeting "its obligations as they mature in the [212] ordinary course of business, with a reasonable use of its credit." (Emphasis supplied)

The opinion further states:

"The burden was on petitioner to establish its insolvency and any deficiency of proof must operate against it. No attempt was made to show inability to meet maturing debts by a reasonable use of credit. It is true that the

oil and gas properties were in the possession and control of the trustees and for that reason could not have been used by the receiver as collateral for a loan, but he had under his control stock of a book value of about \$220,000. Nothing of record is opposed to the idea that this stock could have been used as security for a loan or sold to pay debts. Neither does it appear that an application was ever made to the court for permission to sell receiver's certificates or otherwise raise funds to meet matured obligations."

Whether or not something might have been realized upon "Other Assets" of the Petitioner depends upon what the asset consists of and whether any value could have been realized as well as the interpretation made of the asset in the opinion.

Patents in the amount of \$1,000.00 were charged off as being worthless by the Petitioner on its books in the year 1936 and the deduction for loss claimed by the Petitioner in the year 1936 was disallowed by the Respondent, was an issue raised in this proceeding, but waived by the Petitioner at the time of hearing of this proceeding because of possible worthlessness in a prior year. [213]

The quoted portion of the Opinion states that the receiver "had under his control stock of a book value of about \$220,000.00." In so stating, the Opinion has inadvertently failed to examine and reflect the stipulated facts per Exhibit No. 51. The stock item referred to is set forth on the Balance Sheet, Exhibit No. 51, under the general heading

"Other Assets" and a sub-heading, reading "Capital Stock Issued for Services and Leases, \$219,120.50." This was not stock in the control or possession of the receiver or of Petitioner, but was stock in Petitioner's corporation which had been issued by Petitioner to others for services and property and was an intangible asset of no value whatsoever (being what is commonly called "promotion stock" issued to the promoters of Petitioner) and was simply a bookkeeping debit item offset to the amount of promotion stock reflected in the total capital stock issued by the Petitioner, which capital stock item appeared on the liability side of the Balance Sheet, Exhibit No. 51. The Opinion has inadvertently misconstrued this item. Of course, had Petitioner had corporate stock of a value of \$220,000.00, the situation would have been entirely different, but it did not have any stock of this value or otherwise, this is simply a balancing entry, relating to its promotion stock which had in previous years been "issued" (not to Petitioner, but by Petitioner). [214]

It must be remembered that the undisputed testimony was that, until the funds impounded in the litigation were released, Barnhart Morrow Consolidated was without funds to pay its obligations or conduct its affairs (Transcript, page 20).

The accounts receivable of the Petitioner as set forth in the Findings of Fact in the lump sum of \$35,507.19, and without qualification, would appear to have some value, as so stated, but an examination of the same as detailed in the balance sheet of

the Petitioner, Exhibit 51, and the uncontradicted evidence, reveals an entirely different picture. The accounts receivable on Exhibit 51 are qualified by the statement "Collection and realization on which will exceed one year." This was stipulated to by the Respondent. Considering now each item of said total of \$35,507.19, the evidence shows as follows.

The amount shown receivable from C. C. Julian of \$7,104.61 remained constant from December, 1930 to December 31, 1935. C. C. Julian died a suicide in China in 1934, leaving no estate, and the collection of that account is most doubtful. Certainly nothing could be realized thereon.

The amount shown as due from W. J. Barnhart, former officer of the Petitioner, originated through claims for excessive salary and other items against [215] him by the Petitioner and was settled by an assignment of an interest in the proceeds of production said Barnhart held in an oil well of the East Santa Fe Springs Oil Company. The deferred credit on the Liability side of Petitioner's balance sheet in the amount of \$5,333.25 originated with the assignment from Barnhart, and to that extent is a valuation account of the total amount due from him. To the extent that proceeds of production pertaining to the interest assigned by Barnhart, would produce the total sum of \$21,-978.09, profit would be realized in the amount of the deferred credit. But the amount due

from Barnhart remained constant for the years 1933, 1934 and 1935, as shown on Exhibit 51, and accordingly nothing could be realized on it.

Sundry accounts receivable aggregating \$296.31 are insignificant in amount, and the same remained constant for the years 1932, 1933, 1934 and 1935 as shown on Exhibit 51, and nothing could be realized on them.

The amount receivable from the Texas Co. represents, as stated on Exhibit 51, "Gas Revenues Withheld" which were withheld by that company pending the final determination of the litigation of Julian v. Schwartz.

The amount receivable from J. A. Smith is marked on Exhibit 51 "Contra against indebtedness due him" [216] and nothing could therefore be realized thereon. That amount was taken into consideration in the settlement made with him in 1936, Exhibit 45a, wherein the additional sum of \$16,500.10 was paid to him, which amount is not reflected on the Petitioner's books in 1935 since the final determination in the Julian v. Schwartz matter was not finally determined until October, 1936.

Thus it is clear there was no value to these accounts receivable and nothing was available therefrom to meet obligations of the Petitioner, and nothing to form the basis of credit.

The opinion raises the question as to whether "an application was ever made to the court for permission to sell receiver's certificates or otherwise raise funds to meet matured obligations." To

make such an application to the court would have been folly under the known circumstances of Petitioner's financial condition, its entire existence depending upon the final determination in the Julian v. Schwartz matter. If Petitioner had not been successful in its litigation in that matter, its own receivership would have unquestionably developed into one of liquidation in bankruptcy. No one could have been expected to buy Receiver's Certificates with no assets in the receivership estate other than the possibility of winning a lawsuit; likewise, surely it cannot be presumed that a Court would have authorized the sale of Receiver's Certificates simply for the possibility of raising funds to pay liabilities existing at the time of the creation of the receivership. [217]

#### **ADDITIONAL FINDINGS NECESSARY AS TO INCOME AND EXPENSES OF PETI- TIONER IN YEARS 1936 AND 1937**

Additional findings should be made with respect to Petitioner's income and expenses for the years 1936 and 1937.

Petitioner's income and expenses for the year 1936, set forth in the findings of fact, were apparently taken from Exhibit No. 60, except that the item "oil and gas sales after November 1, less expenses" was apparently inadvertently stated at \$6,436.30, which amount is exactly twice the amount of net operating profit or loss as shown on Exhibit No. 60. The findings of fact, however, do not set forth the income and expenses as respects

each of the oil wells separately as set forth on Exhibits 59 and 60, and such findings are material and necessary in order that the depletion allowance as respects each of the wells separately can be correctly determined. This is particularly so because the Petitioner and the Respondent cannot agree upon what constitutes the gross income and the net income of each of the oil wells separately for the year 1936 and the basis upon which the allowance for depletion must be predicated.

Attached hereto as Appendix A is an affidavit of Geo. F. Meitner, pertaining to a conference with a representative of Respondent, showing the necessity and desirability of a [218] further consideration and hearing to the end that additional findings be made.

The findings of fact further do not set forth the gross income, expenses, and net income of the Petitioner for the year 1937 as respects all of the wells or as to each of the oil wells separately, which gross income, expenses, and net income are reflected in Exhibits Nos. 59 and 61; therefore, it is impossible for the Petitioner and the Respondent to agree as to what constitutes the Petitioner's allowable depletion as respects each of the oil wells separately for the year 1937.

The Opinion states:

'Depletion will accordingly be recomputed on the basis of \$488,903.65 as the gross income from the property, the amount of depletion on the entire property for the year 1936 not to exceed, however, 50% of the net income from

the property. There appears to be no difference of opinion between the parties on the facts necessary to compute the net income from the property."

Since the findings of fact do not determine what constitutes Petitioner's net income from the property for the year 1936 as respects each of the oil wells separately (which was shown on Exhibits Nos. 59, 60 and 61), and further do not determine what constitutes Petitioner's gross income from the property, expenses, and the income from the property as a whole or as respects each of the oil wells separately for the year 1937, [219] additional findings must be had to enable the parties to jointly act under Rule 50.

While it is true that the parties might each submit computations under Rule 50, we earnestly submit that a true, full and accurate making of such computations can only be had after a finding in accordance with the undisputed proof of Exhibits Nos. 59, 60 and 61, as to the gross income, expenses, and net income for each of the wells for each of the years in question. (It is possible that the Board may have considered that Exhibits Nos. 59, 60 and 61 with respect to such income and expenses are part of the Stipulation of Facts, and hence incorporated in the Opinion. They were received without objection, to show the income and expenses, but were not part of the stipulated facts (Record, Page 76).) [220]

## CONCLUSION

Petitioner believes that the Opinion has failed to give effect to the uncontradicted and stipulated evidence in the record as hereinbefore set forth, and that on a reconsideration being had, the Opinion can and should be corrected. We also petition for a rehearing because, if there be any question that the proof as introduced failed to clarify any of these matters, Petitioner asks for a rehearing to the end that all of such matters can be made clear beyond possibility of doubt. The facts involved are not susceptible of dispute, and the interest of justice, we respectfully submit, requires that all of the facts be before the Board with the utmost clarity.

This is a situation where the evidence is known to exist, the facts are known to Respondent, and, if in the labor of preparing the complicated Stipulation of Facts and the Exhibits a part thereof (in the interest of saving the time of this Board) certain matters have been inadvertently overlooked, we know that this Board in the interest of justice will want that situation remedied. We attach hereto as Appendix B, authorities on that subject.

We believe that if a rehearing is granted, a supplement to the Stipulation of facts can be filed in accordance with the facts appearing in the Affidavit of Geo. F. Meitner, [221] hereto attached, and marked Appendix C.

Petitioner, therefore, moves the Board for a reconsideration of the Opinion and Decision herein,

and in the alternative, for a rehearing upon the grounds and for the reasons herein set forth.

This Petitioner also respectfully moves and requests that the Board make additional findings that the income and expenses of Petitioner as to each of the wells for the years 1936 and 1937 was as appears in Exhibits Nos. 59, 60 and 61.

Respectfully submitted,

HAROLD C. MORTON

B. W. BURKHEAD

Attorneys for Petitioner. [222]

## APPENDIX A

State of California,  
County of Los Angeles—ss.

George F. Meitner, being duly sworn, states:

Affiant on September 14, 1942, met with A. M. Swanson, Acting Assistant Technical Advisor in the Los Angeles Office of Respondent, to whom this matter has been referred in the operation of Respondent's office, in an endeavor to work out a computation of matters determined in the decision herein (which would have to be done irrespective of rehearing or other review), so that an order for decision can be jointly submitted under Rule 50. As a result of said conference, affiant is advised by said Swanson that Respondent, as to the years 1936 and 1937, starts with the net income as determined by Respondent in his deficiency letter which led to this proceeding. This ignores the findings of the Board insofar as the same have been made with respect to the year 1936, and likewise ignores the undisputed

proof in Exhibits Nos. 59, 60 and 61, wherein Petitioner has established without contradiction the gross and net incomes of each well for each of said years. Under such circumstances, it will be impossible to submit a joint order for decision.

On Exhibits Nos. 59, 60 and 61, Petitioner established the gross and net income for each well for the years 1936 and [223] 1937 respectively. The findings herein do not determine Petitioner's income for each well for the year 1936, and as to 1937 the findings make no reference to the income and expenses for that year.

Affiant believes that it will be necessary that additional findings be made covering these matters in accordance with Exhibits Nos. 59, 60 and 61. (It is possible that the Board may have inadvertently assumed that Exhibits Nos. 59, 60 and 61 were a part of the stipulated facts, and hence were incorporated by reference in the findings of fact.)

GEO. F. MEITNER

Subscribed and sworn to before me this 15th day of September, 1942.

[Seal]                  ELSIE H. MACDONELL  
Notary Public in and for said County and State.  
[224]

APPENDIX B  
AUTHORITIES

In Underwood vs. Commissioner of Internal Revenue, 56 Fed. (2d) 67, commencing at Page 72 is the following:

“\*\*\* It is settled that the taxpayer has the burden of proof by a number of decisions of the Supreme Court. \* \* \* But we do not think that this rule so restricts the powers of the Board as to require it to countenance an obvious injustice. ‘The Board of Tax Appeals is not a court. It is an executive or administrative board.’ Old Colony Trust Co. v. Commissioner, 279 U. S. 716, 725, 49 S. Ct. 499, 502, 73 L. Ed. 918.

“The Board had ample power under the statute to require the production of additional evidence when it became clear that it could not do injustice to the taxpayer by reason of the deficiencies in the record before it. It was unquestionably incumbent upon the taxpayer to offer the testimony in the first instance, and cases arise where the moving party must suffer the consequences of his own neglect. Here, however, the Board’s own opinion showed that the Commissioner’s action was wrong in a material respect. The information to correct the mistake was readily obtainable from the same source as that from which the gross receipts of the taxpayer were ascertained. Under these circumstances, the Board

should have deferred its decision until testimony showing the amount of the deductions to which the taxpayer was entitled was introduced, and then have redetermined the deficiency. The decision of the Board will therefore be reversed and the case remanded in order that the course indicated may be followed. This action, we think, is authorized by the powers vested in this court by the Revenue Act of 1926, Sec. 1003, 44 Stat. 110, 26 U. S. C. 1226 (26 USCA Sec. 1226), [225] where it is provided that the Circuit Court of Appeals shall have power to modify or reverse a decision of the Board, if not in accordance with the law, with or without remanding the case for a rehearing, as justice may require. In a number of instances, Circuit Courts of Appeals have remanded cases for rehearing when it seemed necessary in order to do justice to the parties. It does not appear in these cases that new evidence was available; but in the instant case the evidence is known to exist and it would be an abuse of discretion to decline to receive it. See *Cohan v. Commissioner* (C.C.A.) 39 F. (2d) 540, 543; *Citrus Soap Co. v. Lucas* (C.C.A.) 42 F. (2d) 372, 373; *Isbell Porter v. Commissioner* (C.C.A.) 40 F. (2d) 432; *Independent Ice & Cold Storage Co. v. Commissioner* (C.C.A.) 50 F. (2d) 31; *Russell v. Commissioner* (C.C.A.) 45 F. (2d) 100. In addition, there is the well-established rule that

an appellate court has the power, without determining and disposing of a case, to remand it to the lower court for further proceedings if the case has been tried on a wrong theory, or the record is not in condition for the appellate court to decide the question presented with justice to all parties concerned. \* \* \*"  
(Emphasis supplied.)

This case was followed in *Eau Claire Book Co. vs. Commissioner*, 65 Fed. (2d) 125, where at Page 126 it is said:

"Likewise, we are satisfied that it would be in the interest of justice, and fairer to both parties, if the cause were remanded with opportunity given to them to supply, if they wish (*Underwood v. Commissioner of Internal Revenue* (C.C.A.) 56 F. (2d) 67, further evidence as to the value of the property and the services rendered for the giving of the notes which were canceled when the bonds were delivered. Likewise, the date of the sale of [226] the bonds by the taxpayer to its stockholders might well be established with greater certainty.

"The order of the Board of Tax Appeals is reversed, with directions to proceed as indicated in this opinion." [227]

## APPENDIX C

## AFFIDAVIT OF GEO. G. MEITNER

State of California,  
County of Los Angeles—ss.

Geo. F. Meitner, being duly sworn, states: That he is the Geo. F. Meitner who testified at the hearing of this matter; that Exhibit No. 57 herein correctly sets forth the cost to Petitioner of Well No. 16, and all the items in said Exhibit contained are in accordance with vouchers, checks and records in the possession of Petitioners; the depreciation referred to in Exhibit No. 57 is depreciation allowed by the Commissioner (Respondent) in years previous to 1936 and depreciation for the years 1936 and 1937 as allowed by Respondent. Petitioner has never expensed intangible drilling costs but same have been capitalized.

Respondent in considering Petitioner's income tax return for the year 1937 redetermined the cost of Well No. 16 for the purpose of calculating the allowable depreciation on the well equipment, which was so redetermined because of the collapse of tubing and casing in Well No. 16 in March of 1937, which resulted in the retiring of the cost of this tubing and casing so collapsed as well as retiring the depreciation applicable to the casing and tubing which had collapsed; that redetermined cost, as well as the depreciation [228] pertaining to the same, was shown on Exhibit No. 57. Petitioner and Respondent were in accord on these matters prior to the petition to this Board.

In conferences leading up to the making of the Stipulation of Facts herein Respondent did not question the amount of the loss on Well No. 16, except as the depletion issue might be determined, but questioned the loss because the well was quit-claimed to J. A. Smith as stated by Mr. Tonjes at Page 10 of the Record in this proceeding.

Petitioner had no credit during the period of its receivership; that the item on Petitioner's Balance Sheet, Exhibit No. 51, "Capital Stock Issued For Services and Leases \$219,120.50", referred to stock issued by Petitioner to others for services and leases, and was simply an intangible item of no value, being what is commonly called "promotion stock".

GEO. F. MEITNER

Subscribed and Sworn to before me this 15th day of September, 1942.

[Seal]                  ELSIE H. MACDONELL  
Notary Public in and for the County of Los Angeles, State of California.

[Endorsed]: U.S.B.T.A. Filed Sep. 17, 1942.

[229]

[Title of Tax Court and Cause.]

## ORDER

Upon consideration of the motion filed herein on September 17, 1942, by petitioner, for reconsideration relates to a rehearing and to reconsidation herein on August 20, 1942, or a rehearing, it is

Ordered: That to the extent that the said motion relates ot a rehearing and to reconsideration of the issues on loss deduction for well No. 16 and insolvency, it be and is hereby denied.

For cause appearing of record, it is further

Ordered: That

(a) The figures \$3,218.15, \$151,599.81, \$116,-115.67, \$142,989.99, and \$60,908.31 be and they are hereby inserted in lieu of the figures \$6,436.30, \$154,817.96, \$119,333.82, \$122,371.37, and \$60,568.15, respectively, appearing on pages 7, 8, 14 and 17 of the printed opinion entered herein.

(b) The following be included in the findings of fact:

“The gross income, operating expenses and net income of petitioner in 1936 and 1937 from the wells shown were as follows: [230]

Well No.	Gross Income		Operating Expenses		Net Income 1936 1937
	1936	1937	1936	1937	
1	\$116,854.21	\$ 27,826.40	\$ 43,683.20	\$ 7,393.66	\$ 73,171.01
2	127,981.99	16,297.57	51,184.71	8,004.45	76,797.28
3	105,567.29	12,837.22	49,689.07	8,087.04	55,878.22
11	17,225.80	462.19	43,821.86	4,477.39	26,596.06*
16	66,329.95	7,464.73	26,292.37	10,723.51	40,037.58
17	70,391.51	7,663.57	22,984.07	8,268.25	47,407.44
Kern Co. Lease	7,673.70			27,920.03	20,246.33*

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\* Loss.,

It is further

Ordered: That allowances for depletion in the taxable years be recomputed under Rule 50 in accordance with the findings of fact of this Court, as amended and supplemented by this order.

[Seal] (S) R. L. DISNEY  
Judge.

Dated: Washington, D. C., December 4, 1942.

〔231〕

[Title of Tax Court and Cause.]

**PETITIONER'S COMPUTATION FOR  
ENTRY OF DECISION**

The attached proposed computation is submitted on behalf of the petitioner, to The Tax Court of the United States (formerly the United States Board of Tax Appeals), in compliance with its opinion determining the issues in this proceeding.

This computation is submitted in accordance with the findings of fact and opinion of the Court, without prejudice to the petitioner's right to contest the correctness of the decision entered herein by the Court, pursuant to the statutes in such cases made and provided.

HAROLD C. MORTON

Attorney for Petitioner

GEO. F. MEITNER

## Certified Public Accountant

for Petitioner

Of Counsel:

B. W. BURKHEAD, ESQ.,  
Los Angeles, Calif.  
March 24, 1943.

Copy served 3/29/43. [232]

#### RECOMPUTATION STATEMENT

In Re: Barnhart-Morrow Consolidated, 1020 Sub-  
way Terminal Building, 417 South Hill Street,  
Los Angeles, California.

Docket No. 105 859

##### Income Tax Liability

Year	Tax Liability	Tax Assessed	Deficiency
1936	\$ 4,282.58	none	\$ 4,282.58
1937	15,816.89	none	15,816.89

A recomputation of the income tax liabilities of the Petitioner for the years 1936 and 1937 has been made, as hereinafter set forth, pursuant to the findings of fact of the United States Board of Tax Appeals (now The Tax Court of the United States) and its opinion promulgated August 20, 1942, which was amended and supplemented by an order dated December 4, 1942.

The decision as amended held as follows:

1. That the debt of \$16,500.00 was ascertained to be worthless and charged off in 1936, is an allowable deduction.
2. That the amount of salary of \$7,000.00 cancelled in 1936 does not constitute taxable income to the petitioner in that year.

3. That the petitioner has failed to prove that it was insolvent at any time during that period within the meaning of Section 14 (d) (2) of the Revenue Act of 1936.

4. That the amount paid to petitioner in 1936, plus the amount of income which had been expended for operating expenses, constitutes gross income received from the property by petitioner in 1936 for depletion purposes.

5. That petitioner may not deduct any amount as a loss, on account of failure to prove the cost of the property on abandonment of oil well number 16.

The computation of net taxable income and depletion allowable for the year 1936 submitted in Exhibit A herewith, are in accordance with the facts found by the Court as set forth in the printed opinion promulgated August 20, 1942, and as such facts were amended and supplemented by paragraph marked (a) of the Order dated December 4, 1942 and the opinion of the Court (page 16 of the printed opinion). Accordingly to the income and [233] expenses of petitioner for the year 1936, as found by the Court and as set forth on pages 7 and 8 of the printed opinion and as amended and supplemented by paragraph (a) of the Order dated December 4, 1942, there has been added to gross income in 1936 the sum of \$223,352.83, representing expenses incurred by the trustees in the operation of the properties, all of which was chargeable to and charged to petitioner and held to be gross income in 1936 from the property. A like sum has been added to the operating expenses for the year

1936 as set forth in paragraph (b) of the Order dated December 4, 1942.

To the extent that paragraph (b) of the Order dated December 4, 1942, determining the gross income for the year 1936 to be an aggregate for all wells of \$504,350.75, is contradictory to the determination of gross income for the year 1936 as determined pursuant to the facts and opinion of the Court as set forth in the preceding paragraph of said Order dated December 4, 1942, in that the gross income of \$504,350.75 so set forth, includes the cash distributed to the petitioner from impounded funds in the year 1937 and subsequently totaling \$122,560.83 less the sum of \$2,073.50, representing discounts received and income from sale of junk, or a net amount of \$120,487.33, the determination so made has been ignored in the computation made for the year 1936.

In conformity with the facts and the opinion, and accordingly contrary to paragraph (b) of the Order dated December 4, 1942, because of the difference in gross income for the year 1936 as set forth above, the aggregate gross income of all wells for the year 1937 totaling \$80,225.38 set forth in said order dated December 4, 1942, has been increased by the amount of \$122,371.37 received by the petitioner in 1937 and so reflective in Exhibit B submitted herewith.

Taxable Year Ended December 31, 1936  
Adjustments to Net Income

Net Income disclosed by the Statutory Notice of deficiency dated September 18, 1940.....	\$103,901.78
As corrected in accordance with the Tax Court's Finding of Facts and Opinion .....	35,712.14
Difference (decrease) .....	<u>\$ 68,189.64</u>
 Increases	
(a) .....	none
Decreases	
(b) Depletion .....	\$32,871.01
(c) Loss—payment to J. A. Smith.....	16,500.10
(d) Accrued Salary .....	7,000.00
(e) Receivership Expenses \$17,574.68	
Less—Amount allowed	
by Respondent .....	5,666.15
 Additional allowable	<u>11,908.53</u>
 Net decrease .....	<u>\$ 68,189.64</u>

[234]

Income Tax		
(a) Income from Oil Wells	1936	1937
Net Income before depletion		
(Exhibit A and B).....	\$146,208.14	\$127,722.42
Reflected in the statutory notice as reported .....	<u>145,995.31</u>	<u>129,790.66</u>
Difference: Increase (decrease) .....	<u>\$ 212.83</u>	<u>\$( 2,068.24)</u>

Represented by :		
Increase (decrease) shown by		
Respondent .....	\$122,773.66	(\$124,439.61)

Apparently being		
Distributions made in 1937 in		
Julian vs. Schwartz .....	122,371.37	(122,371.37)
Distributions subsequent to 1937		
in Julian vs. Schwartz.....	189.46	
Total .....	<u>122,560.83</u>	<u>(122,371.37)</u>
Difference of Respondent Unaccountable .....	<u>\$ 212.83</u>	<u>(\$ 2,068.24)</u>

	1936	1937
(b) Depletion		
Depletion allowable (Exhibit A and B) .....	\$ 80,453.53	\$ 56,672.54
Allowed in statutory notice.....	47,622.52	56,672.54
(Additional) excessive .....	(\$ 32,781.01)	\$ ..... [235]

**Computation of Tax  
Year 1936**

No excess-profits tax due since the first capital stock tax year ended June 30, 1937.

**Normal Tax**

Net income as corrected .....	\$ 35,712.14
Normal tax net income.....	35,712.14
8% on \$ 2,000.00 .....	\$ 160.00
11% on 13,000.00 .....	1,430.00
13% on 20,712.14 .....	2,692.58
Normal Tax .....	4,282.58

**Surtax on Undistributed Profits**

Net Income as corrected.....	\$35,712.04
Less: Normal Tax .....	4,282.58
Adjusted net income .....	31,429.46
Dividends paid .....	none
Undistributed net income.....	31,429.46
7% on \$ 5,000.00 .....	350.00
12% on 3,142.95 .....	377.15
17% on 6,283.90 .....	1,068.26
22% on 6,283.90 .....	1,382.46
27% on 10,718.71 .....	2,894.05
Surtax .....	6,071.92

Total income tax .....	10,354.50
Income tax assessed .....	none
Tentative Tax Liability .....	\$ 10,354.50

Pursuant to the provisions of Section 26 (c) of the Revenue Act of 1936 as amended by the Revenue Act of 1942, Sections 501 (a) (2) and (3), Petitioner does not believe it to be liable for Surtax on Undistributed Profits for the year.

Petitioner contends that it was prohibited from declaring dividends in the year 1936 by the prohibition contained in Section 346 (2) Civil Code of the State of California. [236]

Section 346 of the Civil Code of the State of California reads as follows:

“Sec. 346. Cash or Property Dividends. A corporation may declare dividends payable in cash or in property only as follows:

(1) Out of earned surplus; or

(2) Despite the fact that the net assets of the corporation amount to less than the stated capital, out of net profits earned during the preceding accounting period which shall not be less than six months nor more than one year in duration; or

(3) Out of paid-in surplus or surplus arising from reduction of stated capital subject to the provisions of section 348b, Civil Code, only upon shares entitled to preferential dividends; provided that notice shall be given to the shareholders receiving such dividends of the source thereof prior to or concurrently with the payment thereof.

“Impaired Assets. If the value of the net assets amounts to less, through depreciation, depletion, losses, or otherwise, than the aggregate amount of stated capital attributed to shares having liquidation preferences, the corporation shall not declare dividends out of net profits pursuant to subdivision

(2) of this section, except upon such shares, until the value of the net assets has been restored to such aggregate amount of the stated capital attributed to outstanding shares having liquidation preferences.

“Dividends. No dividends shall be declared when there is reasonable ground for believing that there-upon the corporation’s debts and liabilities would exceed its assets or that it would be unable to meet its debts and liabilities as they mature.

“No dividends shall be declared out of the mere appreciation in the value of its assets not yet realized, nor shall any dividends be declared from earned surplus representing profits derived from an exchange of assets unless and until such profits have been realized or unless the assets received are currently realizable in cash.

“Wasting Asset Corporation. A wasting asset corporation, that is a corporation engaged solely or substantially in the exploitation of mines, oil wells, gas wells, patents or other wasting assets, or organized solely or substantially to liquidate specific assets, may distribute the net income derived from the exploitation of such wasting assets or the net proceeds derived from such liquidation without making any deduction or allowance for the depletion of such assets incidental to the lapse of time, consumption, liquidation or exploitation; subject, however, to adequate provision for meeting debts and liabilities and the [237] liquidation preferences of outstanding shares and to notice to shareholders that no deduction or allowance has been made for such depletion. Added by Stats. 1931, p. 1803; Amended by Stats. 1933, p. 1384.)”

Since the petitioner's accounting period is on the calendar year basis and since its preceding accounting period ending on December 31, 1935 showed a loss of \$6,063.64, and further, since petitioner's "Surplus" on December 31, 1935 was a deficit of \$172,161.65 (pages 6 and 7 of the written opinion promulgated August 20, 1942) that no liability for Surtax on Undistributed Profits for the year 1936 exists.

Accordingly petitioner sets forth herein its liability for income taxes for the year 1936 to be the amount of its normal income tax amounting to \$4,282.58 as submitted herein.

Taxable Year Ended December 31, 1937

Adjustments to Net Income

Net Income disclosed by the statutory notice of Deficiency dated September 18, 1940.....	\$ 61,795.85
As corrected in accordance with the Tax Court's Finding of Facts and Opinion as stated herein.....	61,795.85
Difference (Increase) or Decrease.....	none

Excess Profits Tax

Net Income for excess profits computation .....	\$61,795.85
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Value of capital stock declared in capital stock tax return filed for the year ended June 30, 1937	\$800,000.00
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10% of Declared Value.....	80,000.00
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Dividends Received Credit 85% of \$14,026.50 .....	11,922.52
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Total.....	91,922.52
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Balance subject to excess profits tax.....	none
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Excess Profits Tax .....	none
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Taxable Year Ended December 31, 1937

## Adjustments to Net Income

## Normal Tax

Net Income for Income Tax Com-	
putation .....	\$61,795.85
Dividends Received Credit	
85% of \$14,026.50 .....	11,922.52
Balance subject to normal tax.....	<u>49,873.33</u>
	<u>        </u>
8% on \$ 2,000.00.....\$ 160.00	
11% on 13,000.00..... 1,430.00	
13% on 25,000.00..... 3,250.00	
15% on 9,873.33..... 1,481.00	
Total Normal Tax .....	\$ 6,321.00

## Undistributed Profits Surtax Computation

Net Income for income tax com-	
putation .....	\$61,795.85
Less—Normal tax as above.....	<u>6,321.00</u>
1. Adjusted net income.....	55,474.85
Less—Credit for Dividends Paid.....	<u>6,949.77</u>
2. Undistributed net income .....	<u>48,525.08</u>
	<u>        </u>
3. Portion taxable at 7%:	
\$5,000.00 or 10% of \$55,-	
474.85 whichever is great-	
er .....	\$ 5,547.49        388.32
4. Portion taxable at 12%:	
10% of Item 1 (But not	
more than Item 2 minus	
Item 3) .....	5,547.49        665.70
5. Portion taxable at 17%:	
20% of Item 1 (but not	
more than Item 2 minus	
Items 3 and 4).....	11,094.97        1,886.14
6. Portion taxable at 22%:	
20% of Item 1 (but not	
more than Item 2 minus	
Items 3 to 5).....	11,094.97        2,440.89
7. Portion taxable at 27%:	
Item 2 minus items 3 to 6) 15,240.16	<u>4,114.84</u>
Total Undistributed Profits Tax.....	<u>9,495.89</u>
Total Normal Tax and Surtax.....	<u>\$ 15,816.89</u>

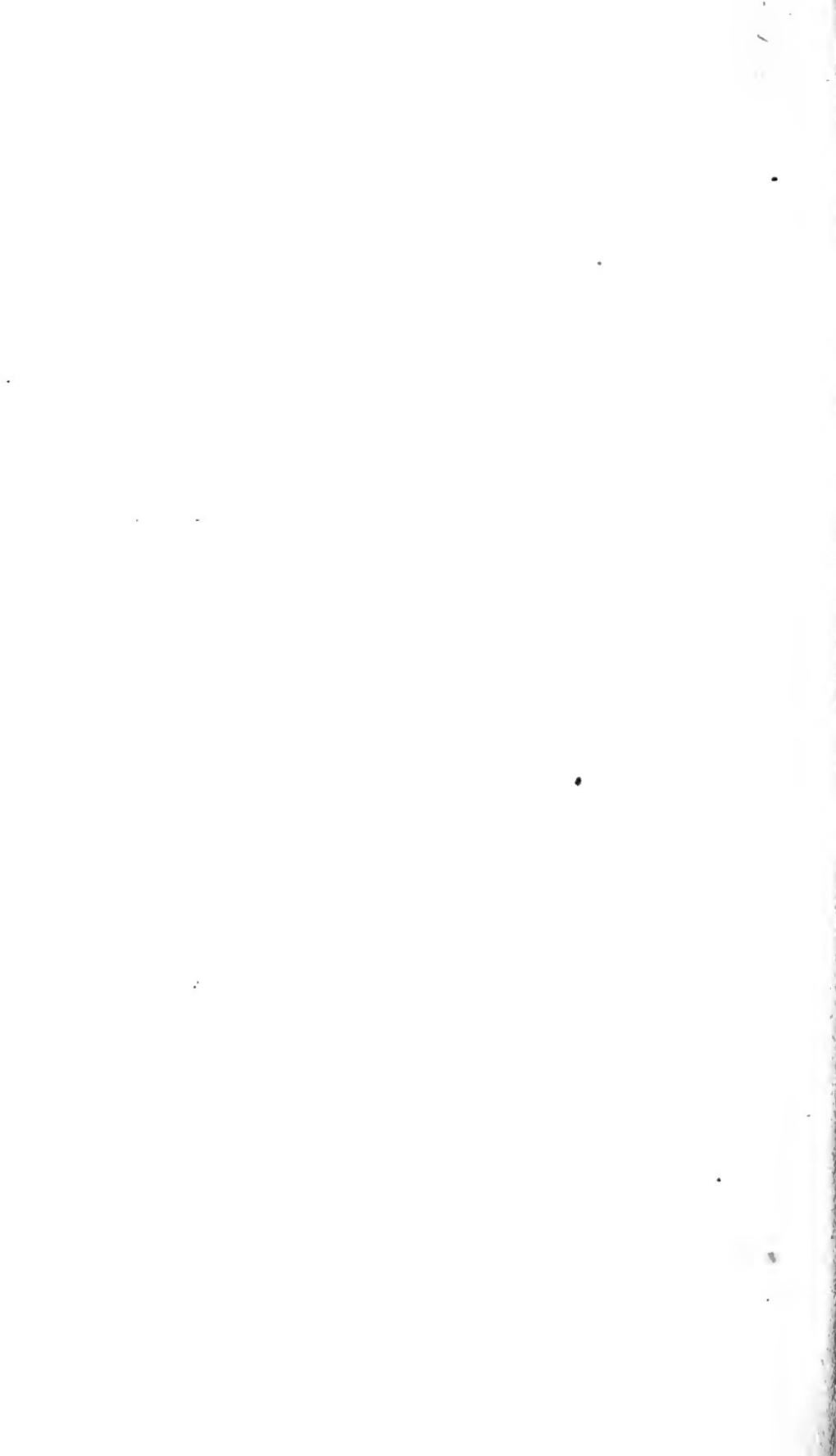


**Springs Lease**

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Well No. 11   Well No. 16   Well No. 17

3   \$(13 579 12)   \$22 758 60   & 25 824 40



## EXHIBIT A

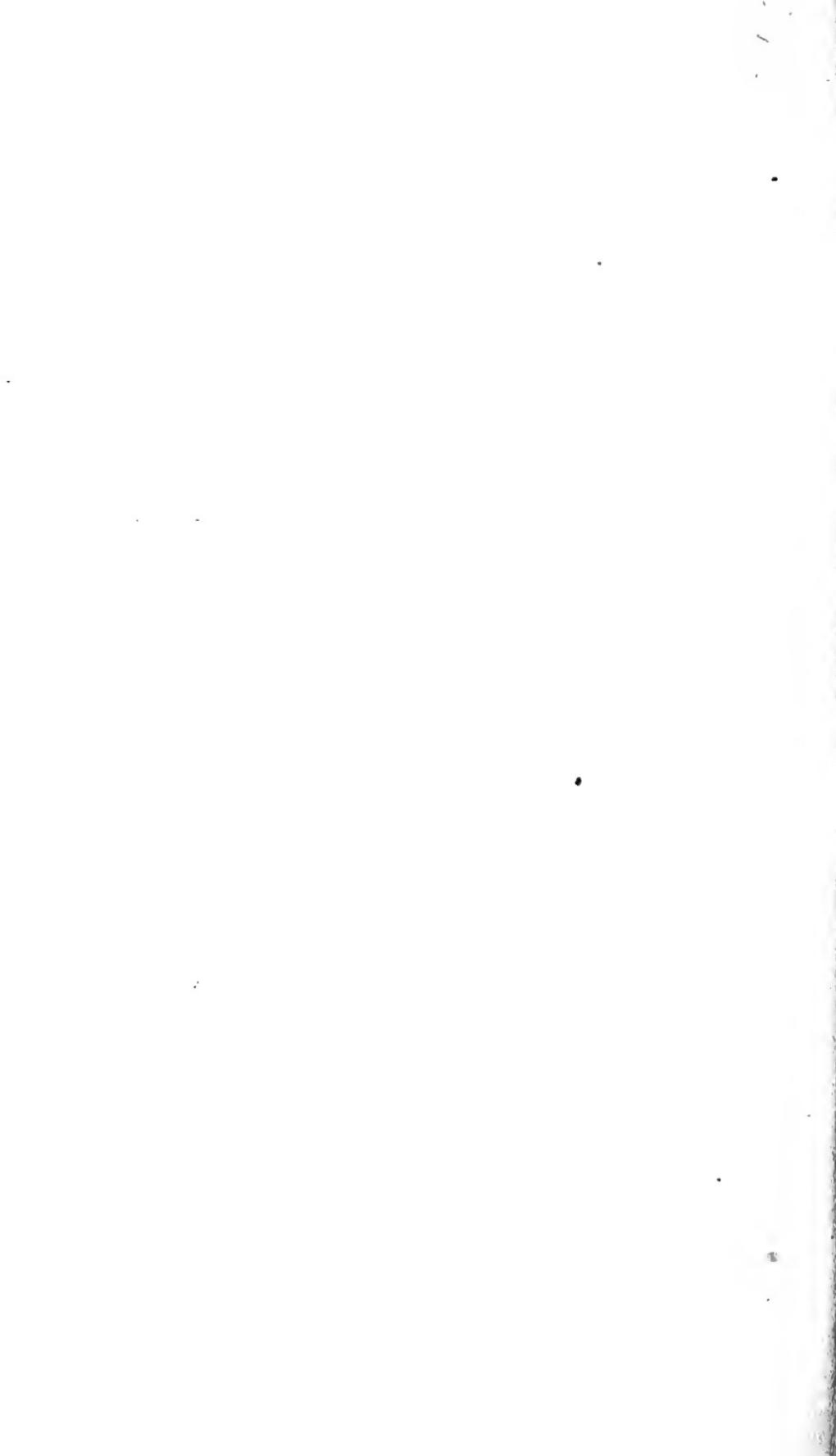
## BARNHART-MORROW CONSOLIDATED

YEAR 1936

	Total	Santa Fe Springs Lease					
		Well No. 1	Well No. 2	Well No. 3	Well No. 11	Well No. 16	Well No. 17
<b>GROSS INCOME</b>							
Impounded Funds							
Distributions in 1936.....	\$142,989.99	\$ 38,039.82	\$ 40,323.67	\$ 29,612.53	\$(13,579.12)	\$22,758.60	\$ 25,834.49
Expenses of Operations .....	223,352.83	41,732.64	49,309.34	47,826.88	41,885.12	21,606.71	20,992.14
Total Impounded Funds.....	366,342.82	79,772.46	89,623.01	77,439.41	28,306.00	44,365.31	46,826.63
Oil and Gas Sales in 1936.....	17,520.60	4,819.82	4,129.49	3,089.21	916.91	2,809.67	1,764.50
Total Gross Income.....	383,863.42	84,592.28	93,762.50	80,528.62	29,222.91	47,165.98	48,591.13
<b>EXPENSES</b>							
Impounded Funds .....	223,352.83	41,732.64	49,309.34	47,826.88	41,885.12	21,606.71	20,992.14
Oil and Gas Sales .....	14,352.45	1,950.56	1,875.37	1,862.19	1,936.74	4,685.66	1,991.93
Total Expenses .....	237,655.28	43,683.20	51,184.71	49,689.07	43,821.86	26,292.37	22,984.07
Net Income Before Depletion.....	146,208.14	40,909.08	42,577.79	30,839.55	(14,598.95)	20,873.61	25,607.06
<b>DEPLETITION</b>							
27½% of Gross Income limited to 50% of Net Income (See below).....	80,403.53	20,454.54	21,288.89	15,419.77	.....	10,436.80	12,803.53
Net Income After Depletion.....	65,804.61	<u>\$20,454.54</u>	<u>\$ 21,288.90</u>	<u>\$ 15,419.78</u>	<u>\$(14,598.95)</u>	<u>\$10,436.81</u>	<u>\$ 12,803.53</u>
<b>OTHER INCOME</b>							
Rental on Drilling Equipment.....	5,000.00						
Claim for interest on Note indebted- ness relinquished in 1936.....	391.67						
Total .....	71,196.28						
<b>OTHER INCOME DEDUCTIONS</b>							
Interest Paid .....	1,409.36						
Loss—Payments to J. A. Smith.....	16,500.10						
Receivership Expenses .....	17,574.68						
Total Income Deductions.....	35,484.14						
Net Taxable Income .....	\$ 35,712.14						
<b>DEPLETION</b>							
27½% of Gross Income .....	\$105,562.42	\$ 23,262.87	\$ 25,784.68	\$ 22,145.37	\$ 8,036.30	\$ 12,970.64	\$ 13,362.56
50% of Net Income before allowance for Depletion .....	80,403.53	20,454.54	21,388.89	15,419.77	.....	10,436.80	12,803.53
Depletion allowable .....	80,403.53	20,454.54	21,288.89	15,419.77	.....	10,436.80	12,803.53

Note: Figures in parentheses are red (loss) figures.

[240]



## EXHIBIT B

## BARNHART-MORROW CONSOLIDATED

YEAR 1937

	Total	Santa Fe Springs Lease					Kern County Land Co. Lease
GROSS INCOME		Well No. 1	Well No. 2	Well No. 3	Well No. 11	Well No. 16	Well No. 17
Impounded Funds							
Distributions released in the year 1937 by the Court of Julian v. Schwartz.....	\$122,371.37	\$ 32,554.62	\$ 34,509.14	\$ 25,342.52	(\$11,621.06)	\$19,476.90	\$ 22,109.25
Oil and Gas Sales in 1937.....	80,225.38	27,826.40	16,297.57	12,837.22	462.19	7,464.73	7,663.57
Total Gross Income .....	202,596.75	60,381.02	50,806.71	38,179.74	( 11,158.87)	26,941.63	29,772.82
EXPENSES							
Oil and Gas Sales .....	74,874.33	7,393.66	8,004.45	8,087.04	4,477.39	10,723.51	8,268.25
NET INCOME BEFORE DEPLETION .....	127,722.42	52,987.36	42,802.26	30,092.70	( 15,636.26)	16,218.12	21,504.57
DEPLETION							
27½% of Gross Income limited to 50% of net income (see below).....	56,672.54	16,604.78	13,971.85	10,499.43	.....	7,408.95	8,187.53
NET INCOME AFTER DEPLETION .....	71,049.88	\$ 36,382.58	\$ 28,830.41	\$ 19,593.27	(\$15,636.26)	\$ 8,809.17	\$ 13,317.04
OTHER INCOME							
Distributions received on Oil Participating Agreements in Julian Wells Nos. 1, 2 and 3, being dividends received for the year 1937.....	14,026.50						
Cash Discounts Received .....	505.69						
Income from sale of Miscellaneous Casing.....	121.42						
Income for drilling oil well for others.....	3,000.00						
Total .....	88,703.49						
OTHER INCOME DEDUCTIONS							
Loss sustained on Davies Well No. 1 abandoned on April 27, 1937 .....	23,818.13						
Interest Paid .....	3,089.51						
Total Income Deductions .....	26,907.64						
NET TAXABLE INCOME .....	\$ 61,795.85						
DEPLETION							
27½% of Gross Income .....	\$ 58,782.81	\$ 16,604.78	\$ 13,971.85	\$ 10,499.43	.....	\$ 7,408.95	\$ 8,187.53
50% of Net Income before allowance for depletion .....	81,802.50	26,493.68	21,401.13	15,046.35	.....	8,109.06	10,752.28
Depletion Allowable .....	56,672.54	16,604.78	13,971.85	10,499.43	.....	7,408.95	8,187.53

Note: Figures in parentheses are red (loss) figures.

[Endorsed]: T.C.U.S. Filed Mar. 26, 1943. [241]



[Title of Tax Court and Cause.]

### REPORTER'S MINUTES

Hearing in Court Room No. 1, Internal Revenue Building, Washington, D. C., on the 5th day of May, 1943, at 9:45 O'clock A. M.

The above-entitled proceeding came on for hearing on this, the 5th day of May, 1943, before the Honorable R. L. Disney, a Judge of the Tax Court of the United States, at Washington, D. C., pursuant to notice of hearing heretofore given, whereupon the following proceedings were had, and testimony heard, to wit:

#### Appearances:

G. F. MEITNER, ESQ.,

Suite 711, 405 South Hill St., Los Angeles, California, Appearing on Behalf of the Petitioner;

ROBERT C. WHITLEY, ESQ.,

(Honorable J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue), Appearing on Behalf of the Commissioner of Internal Revenue. [243]

### PROCEEDINGS

The Clerk: Docket No. 105859, Barnhart-Morrow Consolidated.

Mr. Whitley: Your Honor, please, this is a case which is set for hearing at this time on computation submitted by the parties under Rule 50.

Both parties have submitted computations and there is considerable difference in the deficiencies computed by each party.

In addition to the computation of deficiencies giving effect to depletion, which was an issue in the trial of the case, the petitioner has now raised the question of applicability of the 1942 Act, Section 501 (a) thereof, which deals with a deficit claimed with respect to the taxable year involved.

It is Respondent's position that the provisions of the 1942 Act are not applicable in this case, and that the estate tax, referring to the condition or the prohibition of paying dividends is not applicable to the facts in this case.

Before the conclusion of this hearing, I want to offer a memorandum in support of Respondent's contention, which I believe will set forth clearly Respondent's position on both applicability of the 1942 Act and with respect to depletion. [244]

Judge Disney: I am wondering about the date. It seems rather late to suggest at this hearing the applicability of a section not before suggested.

I wonder about that. Does this bring up something that would probably be called a new trial on it? We are not supposed to re-try this matter on a hearing upon recomputation.

Mr. Meitner: Your Honor, I would like to know what the position of the Court is with respect to the provisions made by the 1942 Act as to their retroactivity on the 1936 Act, which involved this particular matter, and therefore the issue was raised in a recomputation hearing.

In other words, the late passage of the 1942 Act didn't give us much of an opportunity to file the application here until last Monday.

Judge Disney: The Act was passed last fall. It is not a late passage.

Mr. Meitner: Petitioner being in contact with Respondent, represented in Los Angeles, that they would come together on a computation and were able to get together, and in view of the fact mentioned—that they were going to get together, respondent with petitioner's counsel, which was never done; consequently there was not very much to do but for petitioner to raise the issue at this particular time. [245]

Judge Disney: It is in my mind whether this could be raised by a motion for reconsideration. Those 1942 sections—there are several of them, as you know—two or three anyhow that have been considered; and the question in my mind now is the propriety of raising this question on a recomputation proceeding.

Is this going to call for any further facts or further proof or merely a review upon the law?

Mr. Meitner: I think further proof will be necessary and further facts as it involves depletion.

Judge Disney: You mean you have further proof and further facts to offer here today on this question?

Mr. Meitner: No, not today, your Honor because of the situation which is involved. In other words, this is a deficit corporation at this particular time.

Judge Disney: And you are going to have to prove that?

Mr. Meitner: We are going to have to prove that fact—that it is a deficit corporation. Its surplus is in the red and they could not pay the dividends out of Section 46 of the Civil Code of California.

Judge Disney: Let me ask you—I don't want to divert an attorney's mind from his train of thought—is your deficit in the previous years—a clear deficit [246] at the beginning of the year?

Mr. Meitner: At the beginning of the year, yes; and that deficit continues right straight through.

Exhibit No. 51, which was submitted at the trial, gives the balance sheet for 1935 and shows a deficit of some one hundred and seventy-odd thousand dollars, I believe.

The situation involved here involves computation of depletion. Depletion is only computed on a percentage basis. The question is, whether gross depletion would involve the deficit figure as shown. We don't believe it will.

Judge Disney: We don't like to try these cases upon recomputation. We never would get through if we did that. A recomputation is supposed to serve the purpose, as I understand it, and I think it is quite obvious, of stipulating what may be called "the figures", by agreement, if possible, between the parties, and if not possible, finally suggesting the matter to the Court—relieving the Court thereby of the matter of working out the figures of the case.

In other words, trying the points and the parties getting together as near as possible on the figures.

Now, it is obvious that there is a real reason for not bringing in new facts, new proof, new evidence, upon a re- [247] computation. I don't think that that should be considered upon this recomputation at all; that I should hear you on new evidence. But I am not saying that perhaps you might be allowed to file a motion for reconsideration, to set up such new facts if you show proper grounds for doing so.

I don't think we can have a motion upon your present pleading now.

Mr. Meitner: Well, your Honor, the only recomputation here was to bring it to the Court's attention, and enough to argue on the facts with respect to that particular end of it, and to show the applicability of that section.

Judge Disney: How can I apply it unless we have some facts to show you are a deficit corporation. Didn't you say a moment ago you were going to show these facts.

Mr. Meitner: Yes, we have to file or have filed our Exhibit No. 51, which shows this corporation to be a deficit corporation.

Judge Disney: You mean already; you have the evidence already?

Mr. Meitner: In the records, your Honor, yes.

Judge Disney: Do I gather you don't mean to offer new evidence on this subject?

Mr. Meitner: Not entirely new, unless it is required [248] by the Court.

Judge Disney: It is up to you now what evidence you offer. I am not telling you what evidence to offer. You make your case, and the Government makes its case.

Mr. Meitner: Exhibit No. 51, part 2, which shows as of 1935 \$172,161.65, which is a deficit.

Judge Disney: Perhaps I misunderstood you.

Mr. Meitner: The facts are not exactly in the record now—I am not proposing any new evidence unless the Court deems it proper, if new evidence is necessary to sustain that figure. In other words, not now.

Judge Disney: I am not telling you what evidence to make your case or not make your case. If you think you have sufficient upon which to base your view of a recomputation upon this question of the 1942 Act, why of course it would appear your recomputation is properly to be considered. All I was suggesting was that I understood that you needed some further evidence in the record and that I did not propose to receive new evidence in the record upon a recomputation; but it might possibly be you should be allowed to file a motion for reconsideration to bring in new evidence.

Now, that does not appear to be the situation; you are depending on now the evidence in the record.

Mr. Meitner: Right, since Exhibit No. 51 has al-  
[249] ready been submitted as part of our stipulation of facts, showing petitioner to have a deficit of \$172,161.65 as of December 31, 1935, which is the end of its preceding accounting period, and since

Section 346 of the Civil Code of California prohibits the paying out of dividends where a deficit exists, and since Section 501 (a) 2 and 3 of the 1942 Act gives relief to the petitioner, which section amends Section 26(e) of the 1926 Act, giving relief to the petitioner where such deficit does exist and the law prohibits the paying out of dividends where such deficit exists—

Judge Disney: (Interposing) Let's understand each other. As I get this now, you are simply asking that I take into consideration, in arriving at the proper decision here as between you and your opponent, that I take into consideration the facts already in the record and take that 1942 Act into consideration?

Mr. Meitner: That is right, your Honor.

Judge Disney: Is there any reason why that should not be done (addressing Mr. Whitley, counsel for Commissioner)?

Mr. Whitley: As your Honor has pointed out, I considered it not a matter before the Court in the first instance. But if petitioner's counsel, as he now points out, is relying on evidence in the record, then the computation may be given consideration; that the Court may be given the computations under those facts and may properly consider the effect of the 1942 Act, I think.

Judge Disney: I think it is rather apparent that certain courts expect us to take those Acts into consideration and I think that is in general the attitude of the Government. I have had more than one case submitted to me, and I think we probably would

be taking a chance on reversal if we did not take those Acts into consideration, upon the facts in the record. I believe I have agreed between the Government and the parties to do that thing. There is no use in having it go up.

We will take into consideration the 1942 Act upon the facts now in the record, but not receive additional evidence on recomputation.

Mr. Whitley: On that motion your Honor, of the problem, I now offer a memorandum in support of the Respondent's computation under Rule 50, which will deal somewhat with the question of applicability of the 1942 Act.

(At this point, the document referred to was handed to the Clerk by Counsel.)

Judge Disney: Now, does counsel for petitioner have anything further to say. Do you wish time in which to submit a memorandum or do you have one? [251]

Mr. Meitner: I don't have a memorandum prepared, your Honor, at this particular time—not knowing what the situation would be about raising this particular issue, the consideration of the 1942 Act.

Judge Disney: I think I should consider it, and as long as you do not, if you *want will* give you a few days to file a memorandum. I will give you that opportunity if you wish it.

Mr. Meitner: All right, your Honor. I will be glad to do that.

Judge Disney: Unless you have stated the mat-

ter—all you wish in your motion. I haven't looked at your motion yet. I assume this is a matter of some complexity. I want to study it anyway.

Do you want to file a memorandum?

Mr. Meitner: As to the applicability of the 1942 Act?

Judge Disney: And its application to the facts you submitted here. I would be glad to have you do so.

Mr. Meitner: I have quoted the Section of the Revenue Act on Section 346 of the Civil Code of California, your Honor, and I think that controls here.

Judge Disney: If you don't want to file a memorandum, that is up to you.

Mr. Meitner: I don't think any additional memo-[252] randum is necessary under the circumstances, as the facts are in evidence now.

Judge Disney: Very well. I will take the matter under consideration, and the memorandum will be received on the part of the Respondent; and I will decide it within the next few days probably.

Mr. Meitner: The only other issue, your Honor, that seems to be at variance—I don't know whether it is in proper order to take it up now for discussion—the variance in the determination of what is the gross income of the petitioner as computed by Respondent and that as computed by petitioner.

Judge Disney: Of course I will hear you on any discussion as to differences. I want all the light I can get.

Mr. Meitner: The question brought up is that in Section (b) of the Supplemental Order issued under date of December 4, determining what constitutes petitioner's gross income for the year 1936.

Judge Disney: Yes.

Mr. Meitner: That includes the sum of \$122,371.37. That was not received by the petitioner until the year 1937. That particular money could not be received by petitioner until or under the order of the Court in the case of Julian v. Schwartz.

[253]

That was not determined until August 13, 1937, in accordance with the agreement that was entered into by the Commissioner of Internal Revenue and petitioner, and the other parties mentioned in the matter, which I believe was Exhibit No. 42 included in the Stipulation of Facts. That agreement provided that the recipient of the funds distributed by the trustees would be reported in the years received by them, and the \$122,371.37 which was received by Barnhart-Morrow Consolidated was received after the agreement ratified by the Commissioner.

In the event that agreement had not been taken into consideration, it is possible that petitioner wouldn't have received any of that money, because it was not subject to his demand at the time and he was subject to the control of the Court in the matter of Julian v. Schwartz and any income assessed by the trustees would be received by the Commissioner tax-free; and such sum of \$122,371.37 could be said, in 1936, to have been constructively re-

ceived by it when it was still subject to the control of the Court.

Judge Disney: I remember that point, although I don't think it was ever really brought out before. I think that is true. I remember considering it in my own mind at that time.

Mr. Meitner: The supplemental order of the Court [254] on September 4, 1934 amending the original order as of August 20, 1942, in determining the income of the petitioner—that is on pages 7 and 8 of the written opinion—and if that is followed, which was considered in the income of 1936, that constitutes gross income for that year—the (a) order corrects it; then the (b) order shows the gross income for the year 1936, shown in the supplemental order on September 4, is contrary to that item. We raise that question in our recomputation so it is brought to the attention of the Court.

Judge Disney: It will be considered.

Mr. Meitner: Then, of course, any ruling on the 1936 as pointed out in the recomputation would affect the year 1937.

Other than that, your Honor, I think the questions are all presented in our recomputation.

Judge Disney: Anything further from the Respondent?

Mr. Whitley: Nothing further, your Honor. The Respondent has simply followed the supplemental order of the Court in his computation of depletion, and I think that will be clear enough—it is clearly set forth and I don't think any further explanation is necessary on the part of Respondent.

Judge Disney: What do you say about this sum of [255] \$122,371.37 not being constructively received by petitioner in the year 1936?

Mr. Whitley: I think, your Honor, the opinion states definitely what the net income and the gross income was, and those are exactly the figures the Respondent has used in computing the deficiencies.

Judge Disney: All right. The matter will be taken under consideration and the applicability of this 1942 Act will be likewise considered; and it will probably be about two weeks before you get an order.

(Thereupon, at 9:55 o'clock a. m., May 5th, 1943, the hearing on the above matter was concluded.)

[Endorsed]: T. C. U. S. Filed May 8, 1943.

[256]

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[Title of Tax Court and Cause.]

ORDER

The Court having entered its order herein upon December 4, 1942, and certain amounts and figures set forth in paragraph (b) of said order having been inadvertently and erroneously used, it is

Ordered: That paragraph (b) of said order of December 4, 1942, be, and the same is hereby, modified to read as follows:

(b) The following be included in the findings of fact:

'The gross income, operating expenses and net income of petitioner in 1936 and 1937 from the wells shown were as follows:

Well No.	Gross Income*		Operating Expenses 1936	\$ 40,724.34	\$ 52,829.26
	1936	1937			
1	\$ 84,407.54	\$ 60,222.92	\$ 43,683.20	\$ 7,393.66	
2	93,577.76	50,648.61	51,184.71	8,004.45	42,393.05
3	80,343.88	38,021.64	49,689.07	8,087.04	30,654.81
11	29,030.10	11,323.87***	43,821.86	4,477.39	14,791.76**
16	46,981.24	26,783.53	26,292.37	10,723.51	20,688.87
17	48,406.38	29,614.72	22,984.07	8,268.25	25,422.31
Kern Lease		7,673.70		27,920.03	

[257]

\*Gross Income does not include discounts and amounts realized from sales of junk, aggregating \$2,073.50, which amounts are not depletable.

\*\*Net Loss.

\*\*\*Loss, of which \$11,621.06 carried over as part of loss during trustee operation.' ..

It is

Further Ordered: That the parties submit recomputations under Rule 50, in accordance with the findings of fact of this Court as amended and supplemented by this order.

(Seal) (S) R. L. DISNEY

Judge.

Dated: Washington, D. C., July 30, 1943. [258]

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[Title of Tax Court and Cause.]

**PETITIONER'S RECOMPUTATION FOR  
ENTRY OF DECISION**

The attached proposed recomputation is submitted on behalf of the petitioner, to The Tax Court of the United States (formerly the United States Board of Tax Appeals), in compliance with its opinion determining the issues in this proceeding.

This computation is submitted in accordance with the findings of fact and opinion of the Court, without prejudice to the petitioner's right to contest the correctness of the decision entered herein by the

Court, pursuant to the statutes in such cases made and provided.

(Signed) HAROLD C. MORTON  
Attorney for Petitioner

(Signed) GEO. F. MEITNER  
Certified Public Accountant  
for Petitioner

Of Counsel:

B. W. BURKHEAD, ESQ.,  
Los Angeles, Calif.  
December 30, 1943.

[Endrosed]: T. C. U. S. Filed Jan. 1, 1944.

[259]

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### RECOMPUTATION STATEMENT

In Re: Barnhart-Morrow Consolidated, 1020 Subway Terminal Building, 417 South Hill Street, Los Angeles, California

Docket No. 105,859

#### Income Tax Liability

Year	Tax Liability	Tax Assessed	Deficiency
1936	\$ 4,342.62	none	\$ 4,342.62
1937	15,887.41	none	15,887.41

A recomputation of the income tax liabilities of the Petitioner for the years 1936 and 1937 has been made, as hereinafter set forth in the attached schedules, pursuant to the findings of fact of the United States Board of Tax Appeals (now The Tax Court of the United States) and its opinion promulgated August 20, 1942, which was amended and supple-

mented by an order dated December 4, 1942, which order was subsequently amended by order dated July 30, 1943.

The decision as amended held as follows:

1. That the debt of \$16,500.00 was ascertained to be worthless and charged off in 1936, is an allowable deduction.
2. That the amount of salary of \$7,000.00 cancelled in 1936 does not constitute taxable income to the petitioner in that year.
3. That the petitioner has failed to prove that it was insolvent at any time during that period within the meaning of Section 14 (d) (2) of the Revenue Act of 1936.
4. That the amount paid to petitioner in 1936, plus the amount of income which had been expended for operating expenses, constitutes gross income received from the property by petitioner in 1936 for depletion purposes.
5. That petitioner may not deduct any amount as a loss, on account of failure to prove the cost of the property on abandonment of oil well number 16.

[260]

Taxable Year Ended December 31, 1936

Schedule 1

Net Income

Net income disclosed by the Statutory Notice of deficiency dated September 18, 1940.....	\$103,901.78
As adjusted in accordance with the Tax Court's Finding of Facts and opinion as amended—Exhibit A herewith .....	36,173.98
 Difference (decrease) .....	 \$ 67,727.80

Represented by:

Increases		
(a) .....		none
Decreases		
(b) Depletion .....	\$ 32,319.17	
(c) Bad Debt .....	16,500.10	
(d) Accrued Salary .....	7,000.00	
(e) Partnership Expenses .....	\$17,574.68	
Less—Amount allowed by Respondent .....	5,666.15	
Additional Allowable .....	11,908.53	
Net decrease .....	<u><u>\$ 67,727.80</u></u>	

### Schedule 2

#### Explanation of Adjustments

(a) and (b) On July 30, 1943 the Court issued a second order amending the order dated December 4, 1942 which order amended and supplemented the Court's (Board's) opinion promulgated under date of August 20, 1942. The statement submitted by the Court in the order of July 30, 1943 determined the aggregate gross income from all oil wells for the year 1936 to be \$382,746.90; operating expenses to be \$237,655.28 and the aggregate net income before allowance for depletion to be \$145,091.62, details of which are set forth in Exhibit A herewith. Depletion allowance (Exhibit A) is \$79,941.69; that previously allowed by Respondent was \$47,622.52 making additional depletion allowable of \$32,319.17.

(c) and (d) Bad debt and accrued salary cancelled allowed in accordance with the Court's opinion.

(e) The income and expenses of petitioner for the year 1936 as amended was determined by the Court, in accordance with its Findings of Fact, pages 7 and 8 of opinion promulgated August 20, 1942, to include Receivership Expenses amounting to \$17,574.68. The Receivership Expenses allowed by the Respondent amount to \$5,666.15 making an additional amount allowable of \$11,908.53. [261]

### Schedule 3

#### Computation of Tax—Year ended December 31, 1936

No excess-profits tax due since the first capital stock tax year ended June 30, 1937.

##### Normal Tax

Net income as corrected—Schedule 1.....	\$ 36,173.98
Normal tax net income .....	36,173.98
<hr/>	
8% on \$ 2,000.00.....	\$ 160.00
11% on 13,000.00.....	1,430.00
13% on 21,173.98.....	2,752.62
<hr/>	
Normal Tax .....	\$ 4,342.62

##### Surtax on Undistributed Profits

Net income as corrected .....	\$36,173.98
Less: Normal Tax .....	4,342.62
<hr/>	

Adjusted net income .....	\$31,831.36
Dividends paid .....	none
<hr/>	

Undistributed net income .....	\$31,831.36
<hr/>	

7% on \$ 5,000.00.....	\$ 350.00
12% on 3,183.13.....	381.97
17% on 6,366.26.....	1,082.26
22% on 6,366.26.....	1,400.58
27% on 10,915.71.....	2,947.24

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\$ 31,,831.36

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Surtax .....	6,162.05
Total income tax .....	\$ 10,504.67
Income Tax assessed .....	none
Tentative Tax liability .....	\$ 10,504.67

Section 501(a) (2) and (3) of the Revenue Act of 1942 amending Sections 14(a) and 26 of the Revenue Act of 1936 has the effect of allowing for the taxable year 1936 and 1937 a credit, in the case of deficit corporations, for statutory net income which could not be distributed as a dividend because prohibited by law.

Petitioner contends that it was prohibited from declaring dividends in the year 1936 by the prohibition contained in Section 346 (2) Civil Code of the State of California.

The issue was not raised in the Petition of Petitioner since no relief was available until the passage by Congress of the Revenue Act of 1942 and which Act was passed after date of the trial of the case herein. Since Section 501 (a) (2) and (3) of the Revenue Act of 1942 was made retroactively applicable, the tax liability of the Petitioner for the year 1936 must be determined in accordance with the laws applicable thereto.

Section 346 of the Civil Code of the State of California reads as follows:

"Sec. 346. Cash or Property Dividends. A corporation may declare dividends payable in cash or in property only as follows:

- (1) Out of earned surplus; or
- (2) Despite the fact that the net assets of the

corporation amount to less than the stated capital, out of net profits earned during the preceding accounting period which shall not be less than six months nor more than one year in duration; or

(3) Out of paid-in surplus or surplus arising from reduction of stated capital subject to the provisions of section 348b, Civil Code, only upon shares entitled to preferential dividends; provided that notice shall be given to the shareholders receivable such dividends of the source thereof prior to or concurrently with the payment thereof.

“Impaired Assets. If the value of the net assets amounts to less, through depreciation, depletion, leases, or otherwise, than the aggregate amount of stated capital attributed to shares having liquidation preferences, the corporation shall not declare dividends out of net profits pursuant to subdivision (2) of this section, except upon such shares, until the value of the net assets has been restored to such aggregate amount of the stated capital attributed to outstanding shares having liquidation preferences.

“Dividends. No dividends shall be declared when there is reasonable ground for believing that thereupon the corporation’s debts and liabilities would exceed its assets or that it would be unable to meet its debts and liabilities as they mature. [263]

“No dividends shall be declared out of the mere appreciation in the value of its assets not yet realized, nor shall any dividends be declared from earned surplus representing profits derived from an exchange of assets unless and until such profits have

been realized or unless the assets received are currently realizable in cash.

“Wasting Asset Corporation. A wasting asset corporation, that is a corporation engaged solely or substantially in the exploitation of mines, oil wells, gas wells, patents or other wasting assets, or organized solely or substantially to liquidate specific assets, may distribute the net income derived from the exploitation of such wasting assets or the net proceeds derived from such liquidation without making any deduction or allowance for the depletion of such assets incidental to the lapse of time, consumption, liquidation or exploitation; subject, however, to adequate provision for meeting debts and liabilities and the liquidation preferences of outstanding shares and to notice to shareholders that no deduction or allowance has been made for such depletion. (Added by Stats. 1931, p. 1803; Amended by Stats. 1933, p. 1384.)”

Since the petitioner's accounting period is on the calendar year basis and since its preceding accounting period ending on December 31, 1935 showed a loss of \$6,063.64, and further, since petitioner's “Surplus” on December 31, 1935 was a deficit of \$172,161.65 (pages 6 and 7 of the written opinion promulgated August 20, 1942) that no liability for Surtax on Undistributed Profits for the year 1936 exists.

Accordingly petitioner sets forth herein its liability for income taxes for the year 1936 to be the amount of its normal income tax amounting to \$4,342.62 as submitted herein.

Taxable year Ended December 31, 1937

## Schedule 4

## Net Income

Net Income disclosed by the statutory notice of deficiency dated September 18, 1940.....	\$61,795.85
As adjusted in accordance with the Tax Court's Findings of Facts and opinion as amended—Exhibit "B" herewith .....	62,013.25
Difference (Increase) .....	\$ 217.40

## Represented by:

Increases	
(a) Depletion .....	\$ 217.40
	[264]

## Schedule 5

## Explanation of Adjustments

(a) Refer to explanation (a) and (b) of schedule 2 herewith first sentence. The statement submitted by the Court in the order dated July 30, 1943 determined the aggregate gross income from all oil wells for the year 1937 to be \$201,641.25; operating expenses to be \$74,874.33 and the aggregate net income before allowance for depletion to be \$126,766.92, details of which are set forth in Exhibit B herewith. Depletion allowable Exhibit (B) is \$56,455.14; that previously allowed by Respondent was \$56,672.54, making an overallowance for depletion of \$217.40.

## Schedule 6

## Computation of Tax—Year ended December 31, 1937

## Excess Profits Tax

Net Income for excess profits computation.....	\$ 62,013.25
Value of capital stock de- clared in capital stock tax return filed for the year ended June 30, 1937 .....	\$800,000.00
10% of Declared Value.....	80,000.00
Dividends Received credit 85% of \$14,026.50 .....	11,922.52
<hr/>	
Total .....	\$91,922.52
<hr/>	
Balance subject to tax.....	none
<hr/>	
Excess Profits Tax .....	none

## Normal Tax

Net Income; schedule 4 .....	\$ 62,013.25
Less: Dividends received credit (85%) of \$14,026.50 .....	11,922.52
<hr/>	
Normal-tax net income .....	\$ 50,090.73
<hr/>	
8% on \$ 2,000.00 .....	\$ 160.00
11% on 13,000.00 .....	1,430.00
13% on 25,000.00 .....	3,250.00
15% on 10,090.73 .....	1,513.61
<hr/>	
Normal Tax .....	\$ 6,353.61
	[265]

## Surtax on Undistributed Profits

Net Income, Schedule 4.....	\$62,013.25
Less: Normal tax as above.....	6,353.61
1. Adjusted net income .....	55,659.64
Less: Dividends paid credit.....	6,949.77
2. Undistributed net income.....	\$48,709.87
3. Portion taxable at 7%:	
\$5,000.00 or 10% of	
\$55,659.64 whichever is	
greater .....	\$ 5,565.96      389.62
4. Portion taxable at 12%:	
10% of item 1 (But not	
more than item 2 minus	
item 3) .....	5,565.96      667.92
5. Portion taxable at 17%:	
20% of item 1 (But not	
more than item 2 minus	
items 3 and 4).....	11,131.92      1,892.43
6. Portion taxable at 22%:	
20% of item 1 (But not	
more than item 2 minus	
items 3 to 5) .....	11,131.92      2,449.02
7. Portion taxable at 27%:	
Item 2 minus items 3	
to 6 .....	15,314.11      4,134.81
Surtax.....	\$ 9,533.80
Total income tax liability.....	\$ 15,887.41
Income tax assessed .....	none
Deficiency .....	\$ 15,887.41

**as Lease**

Well No. 11	Well No. 16	Well No. 17
(13,579.12)	\$ 22,758.60	\$ 25,834.49
41,885.12	21,606.71	20,992.14

**EXHIBIT A**  
**BARNHART-MORROW CONSOLIDATED**  
**YEAR 1936**

Santa Fe Springs Lease							
GROSS INCOME	Total	Well No. 1	Well No. 2	Well No. 3	Well No. 11	Well No. 16	Well No. 17
Impounded Funds							
Distributions in 1936 .....	\$142,989.99	\$ 38,039.82	\$ 40,323.67	\$29,612.53	\$(13,579.12)	\$ 22,758.60	\$ 25,834.49
Expenses of operations .....	223,352.83	41,732.64	49,309.34	47,826.88	41,885.12	21,606.71	20,992.14
Total Impounded Funds .....	366,342.82	79,772.46	89,633.01	77,439.41	28,306.00	44,365.31	46,826.63
Less discounts and amounts realized from sale of Junk. (see below) .....	1,116.52	184.74	184.74	184.74	192.81	184.74	184.75
Gross Income from Impounded Funds.....	365,226.30	79,597.72	89,448.27	77,254.67	28,113.19	44,180.57	46,641.88
Oil and Gas Sales in 1936.....	17,520.60	4,819.82	4,129.49	3,089.21	916.91	2,800.67	1,764.50
Total Gross Income .....	382,746.90	84,407.54	93,577.76	80,343.88	29,030.10	46,981.24	48,406.38
EXPENSES							
Impounded Funds .....	223,352.83	41,732.64	49,309.34	47,826.88	41,885.12	21,606.71	20,992.14
Oil and Gas Sales .....	14,302.45	1,950.56	1,875.37	1,862.19	1,936.74	4,685.66	1,991.93
Total Expenses .....	237,655.28	43,683.20	51,184.71	49,689.07	43,821.86	26,292.37	22,984.07
NET INCOME BEFORE DEPLETION.....	145,091.62	40,724.34	42,393.05	30,654.81	(14,791.76)	20,688.87	25,422.31
DEPLETION							
27½% of Gross Income limited to 50% of Net In- come. (See below) .....	79,941.69	20,362.17	21,196.52	15,327.41	.....	10,344.43	12,711.16
NET INCOME AFTER DEPLETION.....	65,149.93	\$ 20,362.17	\$ 21,196.53	\$ 15,327.40	\$(14,791.76)	\$ 10,344.44	\$ 12,711.15
OTHER INCOME							
Rental on Drilling Equipment .....	5,000.00						
Claim for interest on Note Indebtedness relin- quished in 1936 .....	391.67						
Discounts and amounts realized from sale of junk	1,116.52						
Total .....	71,658.12						
OTHER INCOME DEDUCTIONS							
Interest Paid .....	1,409.36						
Loss—Payments to J. A. Smith.....	16,500.10						
Receivership Expenses .....	17,574.68						
Total Income Deductions .....	35,484.14						
NET TAXABLE INCOME .....	\$ 36,173.98						
DEPLETION							
27½% of Gross Income .....	\$ 23,212.07	\$ 25,733.88	\$ 22,094.56	.....	\$ 12,919.84	\$ 13,311.75	
50% of Net Income before allowance for Depletion .....	20,362.17	21,196.52	15,327.41	.....	10,344.43	12,711.16	
Depletion Allowable .....	20,362.17	21,196.52	15,327.41	.....	10,344.43	12,711.16	

Note: Figures in parentheses are red (loss) figures.

## EXHIBIT B

## BARNHART-MORROW CONCOLIDATED

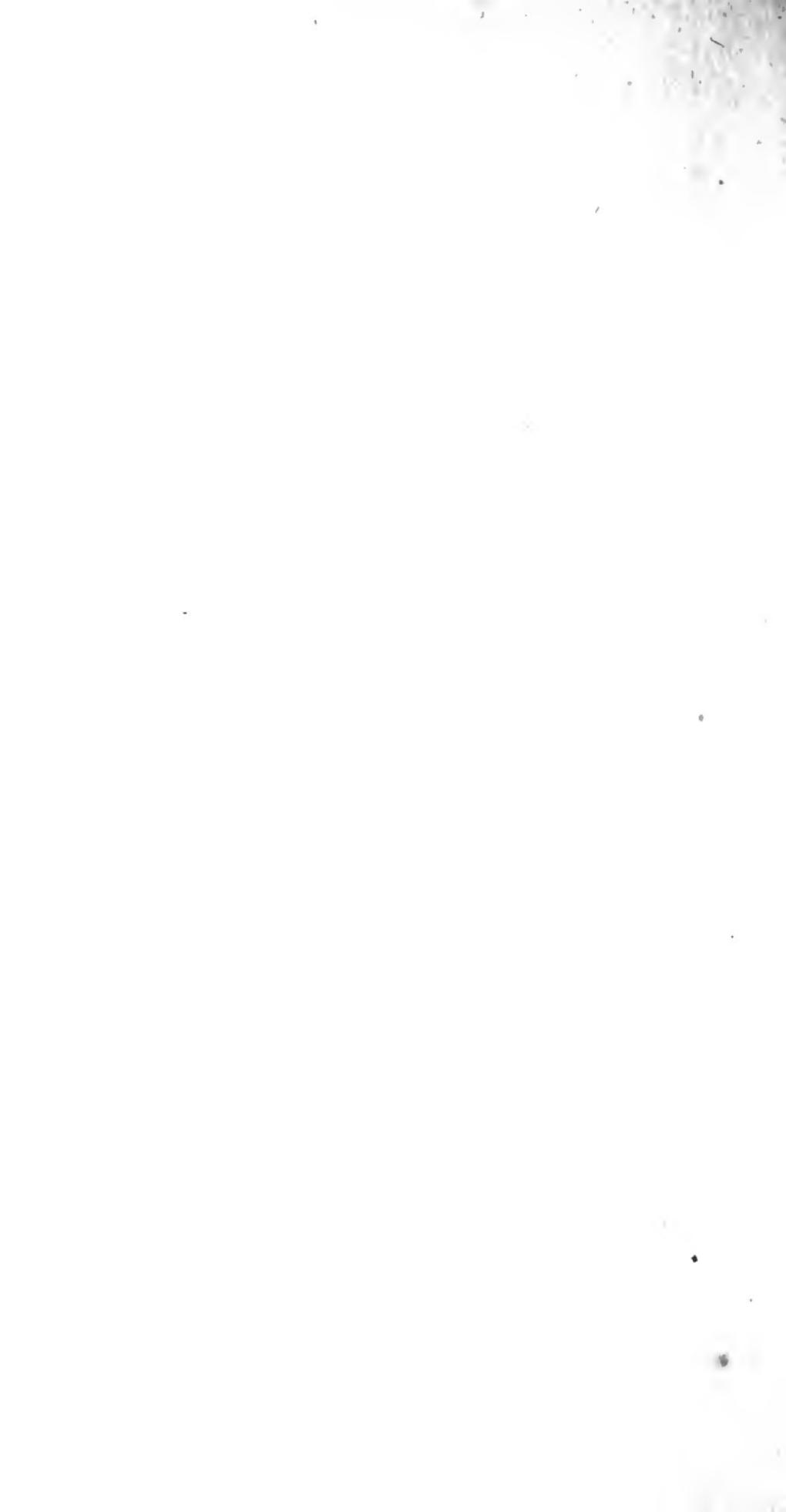
YEAR 1937

GROSS INCOME	Total	Santa Fe Springs Lease						Kern County Land Co. Lease
		Well No. 1	Well No. 2	Well No. 3	Well No. 11	Well No. 16	Well No. 17	
<b>Impounded Funds</b>								
Distributions released in the year 1937 by the Court in Julian V. Schwartz less discounts and amounts realized from sale of junk. (See below) .....	\$122,371.37 955.50	\$ 32,554.62 158.10	\$ 34,509.14 158.10	\$ 25,342.52 158.10	\$ (11,621.06) 165.00	\$ 19,476.90 158.10	\$ 22,109.25 158.10	
Gross Income from Impounded Funds..	121,415.87	32,396.52	34,351.04	25,184.42	(11,786.06)	19,318.80	21,951.15	
Oil and Gas Sales in 1937.....	80,225.38	27,826.40	16,297.57	12,837.22	462.19	7,464.73	7,663.57	7,673.70
Total Gross Income .....	201,641.25	60,222.92	50,648.61	38,021.64	(11,323.87)	26,783.53	29,614.72	7,673.70
<b>EXPENSES</b>								
Oil and Gas Sales .....	74,874.33	7,393.66	8,004.45	8,087.04	4,477.39	10,723.51	8,268.25	27,920.03
NET INCOME BEFORE DEPLETION.....	126,766.92	52,829.26	42,644.16	29,934.60	(15,801.26)	16,060.02	21,346.47	(20,246.33)
<b>DEPLETION</b>								
27½% of Gross Income limited to 50% of net income (see below) .....	56,455.14	16,561.30	13,928.37	10,455.95	.....	7,365.47	8,144.05	.....
NET INCOME AFTER DEPLETION .....	70,311.78	36,267.96	28,715.79	19,478.65	(15,801.26)	8,694.55	13,202.42	(20,246.33)
<b>OTHER INCOME</b>								
Distributions received on Oil Participating Agreements in Julian Wells Nos. 1, 2 and 3, being dividends received for the year 1937	14,026.50							
Cash discounts received .....	505.69							
Discounts and amounts realized from sale of junk. (See above) .....	955.50							
Income from sale of Miscellaneous Casing.....	121.42							
Income for drilling oil well for others.....	3,000.00							
Total.....	88,920.89							
<b>OTHER INCOME DEDUCTIONS</b>								
Loss sustained on Davies Well No. 1 abandoned on April 27, 1937.....	23,818.13							
Interest Paid .....	3,089.51							
Total Income Deductions .....	26,907.64							
NET TAXABLE INCOME .....	\$ 62,013.25							
<b>DEPLETION</b>								
27½% of Gross Income .....	\$ 16,561.30	\$ 13,928.37	\$ 10,455.95	.....	\$ 7,365.47	\$ 8,144.05	\$ 2,110.27	
50% of Net Income before allowance for depletion .....	26,414.63	21,322.08	14,967.30	.....	8,030.01	10,673.23	.....	
Depletion Allowable .....	16,561.30	13,928.37	10,455.95	.....	7,365.47	8,144.05	.....	

Note: Figures in Parentheses are red (loss) figures.

Geo. F. Meitner &amp; Co., Auditors and Accountants

[Endorsed]: T.C.U.S Filed Jan. 1, 1944. [268]



The Tax Court of the United States  
Washington

Docket No. 105859

BARNHART-MORROW CONSOLIDATED,  
Petitioner,  
v.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent.

**DECISION**

Pursuant to the Court's Findings of Fact and Opinion promulgated August 20, 1942, modified by orders dated December 4, 1942, and July 30, 1943, both parties filed computations, which came on for hearing on January 5, 1944. Same having been duly considered, it is

Ordered and Decided: That for the year 1936 there is a deficiency in income tax consisting of normal tax of \$6,052.38 and surtax on undistributed profits of \$8,456.79, making a total deficiency of \$14,-509.17; and that for the year 1937 there is a deficiency in income tax consisting of \$6,353.61, limited however to \$6,321.00, the amount determined in the deficiency notice, and surtax on undistributed profits of \$9,533.80, limited however to \$9,495.89, the amount determined in the deficiency notice, making a total deficiency of \$15,816.89.

(Signed) R. L. DISNEY,  
Judge.

Entered Jan. 24, 1944. [269]

[Title of Tax Court and Cause.]

MOTION FOR REHEARING AND VACATING  
DECISION ENTERED JANUARY 24, 1944

Now comes the Petitioner in the above entitled and numbered proceeding and respectfully moves The Tax Court of the United States (formerly the United States Board of Tax Appeals) for a rehearing of this matter and to vacate the Decision of the Division entered under date of January 24, 1944, for the following reasons:

1. Section 501 (a) (2) and (3) of the Revenue Act of 1942, amending Sections 14(a) and 26 of the Revenue Act of 1936, has the effect of allowing a credit for the taxable years 1936 and 1937, in the case of deficit corporations, for statutory net income, which could not be distributed as a dividend because prohibited by law. [270]

Petitioner contends that it was prohibited by law from declaring dividends in the year 1936 by the prohibition contained in Section 346, Civil Code of the State of California.

The issue was not raised in the Petition of Petitioner, since no relief was available under such circumstances, until the passage by Congress of the Revenue Act of 1942 and which Act was passed after date of the trial on the merits of the case herein. Since Section 501 (a) (2) and (3) of the Revenue Act of 1942 was made retroactively applicable to the years involved in this matter, it is contended by the Petitioner that the tax liability for the year 1936 must be determined in accordance with the

laws applicable thereto in order to avoid an injustice to the Petitioner.

Certain facts sustaining Petitioner's contention are now in the record and additional facts to further substantiate Petitioner's contention in the application of Section 501 of the Revenue Act of 1942, which facts were not material to the issues involved at the time of the hearing, will be presented to the Court at such rehearing of the matter. The additional evidence that will be submitted will be an analysis of the Deficit Account sustaining Petitioner's contention that such "deficit existed in accumulated earnings and profits as of the close of the preceding taxable year," for purpose of Section 501.

[271]

The applicability of Section 501 of the Revenue Act of 1942 was called to the attention of the Court in Petitioner's computation for entry of decision under Rule 50, dated March 24, 1943 and hearing had thereon May 5, 1943.

Pursuant to supplemental order of the Court, dated July 30, 1943, Petitioner's Recomputation under Rule 50, dated December 30, 1943, and Memorandum in Support of Rule 50 Recomputation, dated January 3, 1944, were filed with the Court and therein the attention of the Court was directed again to the applicability of Section 501 of the Revenue Act of 1942 to the year 1936.

Since no additional finding of fact was made with respect to the applicability of Section 501 of the Revenue Act of 1942, nor mention thereof made or reflected in the determination of the tax liability in

the Decision of the Division entered January 24, 1944, it now appears that no consideration was given to the applicability of said Section, or, if consideration were given, it could not have been properly considered at that time since the Exhibits, reflecting the facts in the record pertaining to this issue and to which Exhibits Petitioner referred to in its recomputation statement and memorandum in support thereof, were not before the Court at any time between the filing of Petitioner's memorandum in support of Rule 50 recomputation and January 24, 1944, the date of [272] the Decision. This absence of the Exhibits was due to an error of the Clerk of this Court in mailing all of the Exhibits to counsel for Petitioner at Los Angeles, California, on November 2, 1943, as appears from the Affidavit of Harold C. Morton, attached hereto, made a part hereof and marked Exhibit "A", and as further appears from the Affidavit of Ruby Spicer, attached hereto, made a part hereof and marked Exhibit "B". Said memorandum had been filed in lieu of oral argument, due to the inability of Petitioner's counsel to be present on the date set by this Court for hearing under Rule 50.

2. The Decision of the Division with respect to the issue involving whether or not the Petitioner was insolvent during the year 1936 and the Opinion rendered that the Petitioner was not insolvent for said year are contrary to the stipulations by the parties, to the Exhibits in the record, and to the findings of fact. The balance sheet of the Petitioner at the close of the year 1935 shows an item

"Capital Stock issued for services and leases, \$219,-120.50," (page 7 of Opinion promulgated August 20, 1942.) This item, the Opinion misconstrues to be stock owned by the Petitioner and under its control, having a book value of about \$220,000.00 (page 13 of Opinion promulgated August 20, 1942.) Such item, in fact, represents capital stock issued by the Petitioner, and not [273] stock issued to it, and, therefore, cannot be stock owned by it. Since the item does not represent stock owned by the Company, it could not be used as security for a loan nor sold to pay debts, as stated in the Opinion (page 13). The misapprehension of this item by the Court is based upon an assumption that the item represents stock owned by the Petitioner, which it could have used for credit purposes or sold in order to pay its debts. The "insolvency issue" was stated at length in the "Motion and Application for Reconsideration of Decision or Rehearing and For Additional Findings" heretofore filed with the Court in September, 1942, and to which the attention of the Court is directed.

3. The Decision of the Division, pertaining to the year 1936, is contrary to the stipulations in the record and the findings of fact (pages 7 and 8 of Opinion promulgated August 20, 1942) with respect to Receivership Expenses amounting to \$17,574.68, by not allowing as an additional deduction from income of that year the sum of \$11,908.53.

4. The Opinion promulgated August 20, 1942 and the decision rendered pursuant thereto are contrary to the stipulated facts and testimony in the

record with respect to the disallowance as a loss deduction in the year 1937 of the loss claimed by Petitioner in connection with the [274] relinquishment of its interest in Well No. 16. The assumption by the Court with respect to the disposition made on the records of the Petitioner or in its prior income tax returns, concerning issues which it raises in connection with items appearing on Exhibit 57, assumes as a conclusion that a prior tax benefit was received by the Petitioner, which assumption or conclusion is not supported by the evidence in the record and is contrary to the actual facts, stipulations and testimony in the record.

5. The Exhibits of Petitioner, filed with the stipulation of facts or introduced in evidence at the hearing on the merits, were not before the Court from November 2, 1943, to January 24, 1944, during which time there were filed for consideration Petitioner's Recomputation Under Rule 50 and Memorandum In Support Thereof (in lieu of oral argument on recomputation), which refer to various of said Exhibits and which were based thereon (Affidavits of Harold C. Morton and Ruby Spicer attached hereto). The foregoing, Petitioner respectfully submits, prevented a full and fair consideration of Petitioner's Recomputation Under Rule 50 and Memorandum In Support Thereof.

Wherefore, Petitioner respectfully prays that this Court vacate the Decision herein, dated January

24, 1944, [275] and direct and order that a rehearing be had of this matter.

(Signed) HAROLD C. MORTON,  
Attorney for Petitioner,  
1126 Pacific Mutual Building,  
523 West Sixth Street,  
Los Angeles, 14, California.

(Signed) GEO. F. MEITNER,  
Certified Public Accountant  
for Petitioner,  
711 Wright and Callender  
Building,  
405 South Hill Street,  
Los Angeles, 13, California.

Of Counsel:

B. W. BURKHEAD, ESQ.

Los Angeles, California, February 15, 1944. [276]

EXHIBIT "A"

[Title of Tax Court and Cause.]

AFFIDAVIT OF HAROLD C. MORTON

State of California,  
County of Los Angeles—ss.

Harold C. Morton, being first duly sworn, deposes and says:

That he is a member of the law firm of Hanna and Morton, with offices located at 1126 Pacific Mutual Building, 523 West Sixth Street, Los Angeles, 14, California:

That B. W. Burkhead, Esquire, formerly was associated with the firm of Hanna And Morton; that said B. W. Burkhead has been in the Armed Forces for many months last past;

That on February 14, 1944, Ruby Spicer, an employee of the firm of Hanna And Morton, called to the attention of affiant a letter, dated January 27, 1944, written by the Honorable B. D. Gamble, Clerk of the Tax Court of the United [277] addressed to B. W. Burkhead, Esq., wherein a request was made for the return of certain original documents, being Petitioner's exhibits in this case, which, through inadvertence, had been mailed in November, 1943, by the Clerk of this Court to the said B. W. Burkhead; a copy of said letter of January 27, 1944, is hereunto attached, made a part hereof and marked Exhibit "1"; by transmittal letter, dated February 15, 1944, affiant answered said letter of the Clerk, dated January 27, 1944, and returned to him the original Petitioner's exhibits in this case;

Affiant did not know that the envelope from the United States Tax Court, addressed to the said B. W. Burkhead, which was received by this office on November 6, 1943, contained the original Petitioner's exhibits in this case; upon the receipt at that time of such envelope, affiant was advised by Ruby Spicer, an employee of the firm of Hanna And Morton, that an envelope had been received from the United States Tax Court, addressed to B. W. Burkhead, Esq., containing a large number of papers pertaining to Barnhart-Morrow Con-

solidated, and affiant, without examining the documents therein contained, instructed the said Ruby Spicer to place the same in the office file of Hanna And Morton pertaining to Barnhart-Morrow Consolidated. [278]

Because of inability of counsel for Petitioner to be present on January 5, 1944, at the time set for hearing under Rule 50, Petitioner filed a Memorandum In Support of Recomputation Under Rule 50, in lieu of personal appearance; said Memorandum referred to and relied upon various of said Exhibits and could not be fully and fairly considered by the Court without the presence of said Exhibits.

Further, affiant sayeth not.

(Signed) HAROLD C. MORTON

1126 Pacific Mutual Building,  
523 West Sixth Street, Los  
Angeles, 14, California

Subscribed and Sworn to before me this 15th day of February, 1944.

[Notarial Seal] LAURA TEETER

Notary Public in and for the County of Los Angeles, State of California.

My Commission Expires July 21, 1947. [279]

**EXHIBIT "1" TO EXHIBIT "A"**

The Tax Court of the United States  
Washington

January 27, 1944.

B. W. Burkhead, Esq.,  
1126 Pacific Mutual Bldg.,  
Los Angeles, California.

In re: Barnhart-Morrow Consolidated,  
Docket Number 105,859

Sir:

Through clerical error petitioner's exhibits 1 through 55, letters and statements, 56, stipulation to dismiss, 57, statement of loss on oil wells, 58, gross proceeds of production, 59, statement 2 pages, 60, statement, 61, statement were returned to you November 2, 1943.

Under the circumstances I am obliged to request the return to this office of said petitioner's exhibits.

I regret very much any annoyance this error may cause.

Respectfully,

(Signed) B. D. GAMBLE,  
Clerk [280]

BDG/cgh

For Victory Buy United States War Bonds and  
Stamps.

## EXHIBIT "B"

[Title of Tax Court and Cause.]

## AFFIDAVIT OF RUBY SPICER

State of California,

County of Los Angeles—ss.

Ruby Spicer, being first duly sworn, deposes and says:

That she is an employee of the law firm of Hanna And Morton, which has its offices at 1126 Pacific Mutual Building, 523 West Sixth Street, Los Angeles, 14, California;

That Mr. B. W. Burkhead, counsel in the above-entitled matter, formerly was associated with the firm of Hanna And Morton, but is now in the Armed Forces of the United States of America and has been for many months last past;

That on November 6, 1943, there was received in the Office of Hanna And Morton, sent by ordinary mail, an envelope (no letter or other communication being enclosed), [281] addressed to B. W. Burkhead, Esq., 1126 Pacific Mutual Bldg., 523 West 6th St., Los Angeles, Calif.; said envelope showed that it was from the United States Tax Court, Washington, D. C.; affiant opened the same and observed that it contained various documents pertaining to the income tax situation of Barnhart-Morrow Consolidated and thereupon placed the same in the file of this office pertaining thereto; and that said documents remained in such file in the Office of Hanna And Morton until February 15, 1944, at which time they were mailed to the Honor-

able B. D. Gamble, Clerk of The Tax Court of the United States, Washington, D. C., pursuant to a letter of request therefor, written by said Clerk under date of January 27, 1944, which said request was answered by letter returning said documents, written by Mr. Harold C. Morton of the firm of Hanna And Morton under date of February 15, 1944.

Further, affiant sayeth not.

(Signed)      RUBY SPICER

Care of Hanna And Morton, 1126 Pacific Mutual Building, 523 West Sixth Street, Los Angeles, 14, California.

Subscribed and Sworn to before me this 15th day of February, 1944.

[Notarial Seal]

(Signed)      LAURA TEETER

Notary Public in and for the County of Los Angeles, State of California.

My Commission Expires July 21, 1947.

[Endorsed]: T.C.U.S. Filed Feb. 17, 1944. [282]

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[Title of Tax Court and Cause.]

### ORDER

Petitioner having filed its motion for rehearing and to vacate decision entered herein on January 24, 1944, the record in this case has again been fully examined and studied. All of the matters presented by the present motion had, prior to the filing thereof, been thoroughly considered. On December 4, 1942, motion filed September 17, 1942, for rehearing,

including consideration of the issues now raised as to loss on Well No. 16 and insolvency, was denied. The matter of receivership expense was waived at the original hearing, and was not discussed in petitioner's briefs nor at the hearing under Rule 50. The above issues were nevertheless reconsidered because the figures involved were incorporated in the recomputations submitted.

The opinion was promulgated on August 20, 1942, prior to the approval, on October 21, 1942, of the Revenue Act of 1942. No motion was filed to apply section 501 (a) (2) and (3) of that Act, by presentation of additional evidence or otherwise, nor any application made to amend the pleadings to cover the issue. The question of whether, under such section, petitioner was a deficit corporation on [283] December 31, 1935, was first suggested, and the petitioner's contention thereon first set forth in a Rule 50 recomputation filed by the petitioner on March 26, 1943, by reference to the balance sheet of December 31, 1935, as set forth in the findings of fact. The necessity for further evidence on the issue was not alleged. The respondent filed his recomputation and memorandum, presenting opposition to deficit credit, and pointing out that the issue had not theretofore been presented prior to Rule 50 recomputation. On May 5, 1943, the Court, after continuance at petitioner's request, heard both parties, through counsel, upon the recomputations submitted, including the question of applicability of section 501, and the petitioner then submitted the matter upon the facts already in the record, and

elected not to file a memorandum on the subject, stating that the facts were in the record. The record, as shown in the findings of fact, then contained the balance sheet of the petitioner at the crucial date, the close of 1935. Upon the evidence of record and after due consideration thereof, and of the question of the applicability of section 501 of the Revenue Act of 1942, the Court on July 30, 1943, entered its order modifying and supplementing the original findings of fact and requiring the parties to submit recomputations under Rule 50, in accordance with such amended and supplemented findings of fact. Revised recomputations were filed on November 18, 1943, by the respondent, and upon January 1, 1944, by the petitioner. The application of section 501 was again presented in petitioner's recomputation, with no suggestion of additional evidence being necessary, and petitioner's contention set forth again in its memorandum filed January 7, 1944. The matter came on for hearing on January 5, [284] 1944, after continuance at petitioner's request. On January 24, 1944, after full consideration of all matters, the Court entered the decision to which petitioner's motion is directed. By inadvertence of the Clerk of the Court, the exhibits had been mailed to counsel for the petitioner on November 2, 1943, including Exhibit 51, which includes the balance sheet of petitioner at the close of the year 1935. Such exhibits were returned to the Court on February 19, 1944. The present motion suggests the absence of such exhibits as indicative of lack of consideration by the Court of

the applicability of section 501 of the Revenue Act of 1942. The assumption is without foundation, and such absence of the exhibits was of no effect for the reason that the only record evidence affecting the question of deficit corporation and section 501 of the Revenue Act of 1942, to wit, the balance sheet as at the close of 1935, was contained in the original findings of fact of the Court, and before it during the absence of the exhibits, and further because the matter had been thoroughly considered prior to the mailing of the exhibits to the petitioner, after submission of the question upon such evidence at the hearing on May 5, 1943. The decision of January 24, 1944, contained no recitations in connection with the question, for the reason that it had been presented only upon recomputation for decision under Rule 50, which is a rule for ascertainment of the parties' figures on the case as it stands determined, after disposition of any applications for rehearing, reconsideration, or modification. It was considered neither necessary nor proper to set out in a decision an opinion upon the deficit credit point, and the figures decided upon necessarily reflected the conclusion thereon. [285]

The present motion raises no question not already examined and considered over a long period, and so far as suggestion of new evidence is concerned, comes after petitioner's decision on May 5, 1943, to stand upon the original evidence. The only additional evidence now suggested by motion is an analysis of the deficit account. Nothing newly discovered, since the hearing on the issue on May 5,

1943, is suggested. The record evidence has, upon the earlier presentations of the question, been found insufficient to show right to the deficit corporation credit. In the light of the entire record here, and after repeated presentation and consideration of this question, no just reason is found to vacate the decision of January 24, 1944, and the petitioner's motion is therefore denied.

(Signed)      R. L. DISNEY  
                  Judge.

Dated: Washington, D. C., February 29, 1944.

[286]

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In the United States Circuit Court of Appeals  
for the Ninth Circuit

T. C. Docket No. 105859

BARNHART-MORROW CONSOLIDATED,  
Petitioner,  
vs.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent.

PETITION FOR REVIEW AND  
ASSIGNMENTS OR ERROR

To the Honorable Judges of the United States Circuit Court of Appeals for the Ninth Circuit:

The petition of Barnhart-Morrow Consolidated respectfully shows:

## I.

Petitioner is a corporation organized under the laws of the State of California. Its income tax returns for the calendar years 1936 and 1937 here involved were filed with the Collector of Internal Revenue for the Sixth District of California.

## II.

On September 18, 1940, respondent sent to petitioner a notice of deficiencies in income tax for the calendar years 1936 and 1937, in the sums of \$32,-767.96 and \$15,816.89 respectively. Within ninety days thereafter [287] petitioner filed with the United States Board of Tax Appeals a petition for redetermination of the said asserted deficiencies. On August 20, 1942, the Board of Tax Appeals promulgated its opinion, reported in Volume 47 Board of Tax Appeal Reports, at page 590. On September 17, 1942, petitioner filed a motion for reconsideration of the opinion, or in the alternative, for a further hearing, and for additional findings. By an order dated December 4, 1942, the Board (now the Tax Court of the United States) denied the motion for reconsideration or rehearing, but corrected and made additions to the findings of fact contained in its opinion. After a hearing under Rule 50, the Tax Court on July 30, 1943, modified the additional findings contained in its order of December 4, 1942, and ordered the submission of further computations under Rule 50. The decision, entered January 24, 1944, redetermined the deficiency for 1936 at \$14,509.17 and upheld the re-

spondent's determination of a \$15,816.89 deficiency for 1937. On February 15, 1944, petitioner filed a motion to vacate the decision and for a rehearing. This motion was denied by the Tax Court in an order dated February 29, 1944, by which order the Court also decided, adversely to petitioner, two of the issues involved in this proceeding.

### III.

The nature of the controversy is as follows: [288]

(a) Petitioner contends that during a portion of the year 1936 it was insolvent and in receivership and, therefore, that for the year 1936 it was exempted from surtax on undistributed profits by Section 14(d)(2) of the Revenue Act of 1936. Respondent denies that petitioner was insolvent during any portion of said year.

(b) Petitioner contends that at the close of the year 1935 it had a deficit of \$172,161.65 in accumulated earnings and profits and was prohibited by Section 346 of the Civil Code of the State of California from paying dividends during the existence of such deficit, and, therefore, that under Sections 14(a)(2) and 26(c)(3) of the Revenue Act of 1936, as amended by Section 501(a) of the Revenue Act of 1942, it is entitled to deduct the amount of such deficit in determining its undistributed net income subject to surtax for the year 1936. Respondent contends that the evidence is insufficient to show the existence of such deficit.

(c) Petitioner contends that its liability for receivership expenses paid in 1936 in the sum of

\$17,574.68 accrued on November 12, 1936, when said expenses were approved by the Court which appointed the receiver and authorized to be paid, and therefore, that said sum is deductible under Section 23(a) of the Revenue Act of 1936 in determining net income and undistributed net income for that year. Respondent denies that petitioner is entitled to deduct \$11,908.53 [289] of the said sum of \$17,574.68 on the ground that petitioner's liability for payment of said sum of \$11,908.53 accrued in years prior to 1936.

(d) Petitioner contends that in determining net income and undistributed net income for the year 1937 it is entitled, under Section 23(f) of the Revenue Act of 1936, to deduct \$42,900.15 for the loss sustained upon relinquishment of its one-half interest in an oil well known as Well No. 16, which had been operating at a loss and which required repairs the cost of which could not be determined in advance. Respondent denies petitioner's right to this deduction on the ground that the evidence is insufficient to prove the true cost or other basis of petitioner's interest in said well.

#### IV.

Petitioner assigns as error the following acts and omissions of the Tax Court:

(1) The Court erred in holding and deciding that petitioner was not insolvent, within the meaning of Section 14(d)(2) of the Revenue Act of 1936, at any time during the year 1936.

(2) The Court erred in holding and deciding that the evidence was insufficient to show petitioner's right under Sections 14(a)(2) and 26(c)(3) of the Revenue Act of 1936, as amended by Section 501(a) of the Revenue Act of 1942, to deduct its deficit in accumulated earnings [290] and profits as of December 31, 1935, in determining undistributed net income for the year 1936.

(3) The Court erred in failing to make findings of fact with respect to petitioner's asserted right to the deduction referred to in the preceding assignment.

(4) The Court erred in denying petitioner a re-hearing for the purpose of proving its right to the deduction referred to in paragraph (2) of these assignments.

(5) The Court erred in holding and deciding that petitioner was not entitled, in determining its net income and undistributed net income for the year 1936, to deduct \$11,908.53 paid in 1936 as receivership expenses.

(6) The Court erred in holding and deciding that petitioner was not entitled, in determining net income and undistributed net income for the year 1937, to deduct the loss sustained upon relinquishment of its one-half interest in Well No. 16.

(7) The Court erred in redetermining a deficiency of \$14,509.17 in petitioner's income tax and undistributed profits surtax for the calendar year 1936.

(8) The Court erred in upholding respondent's determination of a deficiency of \$15,816.89 in pe-

tioner's income tax and undistributed profits sur-tax for the calendar year 1937.

Wherefore, petitioner prays that this Honorable Court review and reverse the said decision and order of [291] the Tax Court, and remand the case for a hearing, to the end that the errors herein complained of may be corrected.

HAROLD C. MORTON

LEON B. BROWN

By /s/ LEON B. BROWN

Attorneys for Petitioner

1126 Pacific Mutual Bldg.

Los Angeles 14, California

(Duly verified.)

[Endorsed]: Filed T.C.U.S. May 15, 1944. [292]

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U.S. GOVERNMENT PRINTING OFFICE: 1944 10-1000

[Title of Circuit Court of Appeals and Cause.]

NOTICE OF FILING PETITION FOR  
REVIEW.

To the Chief Counsel of the Bureau of Internal Revenue, Washington, D. C.

You are hereby notified that Barnhart-Morrow Consolidated did on the day of May, 1944, file with the Clerk of the Tax Court of the United States, at Washington, D. C., a petition for review by the United States Circuit Court of Appeals for the Ninth Circuit of the decision of the Tax Court heretofore rendered in the above entitled case. A copy of the petition for review and assignments of

error, as filed, is hereto attached and served upon you.

Dated: May 9, 1944.

HAROLD C. MORTON

LEON B. BROWN

By /s/ LEON B. BROWN

Attorneys for said Barnhart-  
Morrow Consolidated [294]

Personal service of the above and foregoing notice, together with a copy of the petition for review and assignments of error mentioned therein, is hereby acknowledged this 16th day of May, 1944.

J. P. WENCHEL

C.A.R.

Chief Counsel

Bureau of Internal Revenue

[Endorsed]: T.C.U.S. Filed May 16, 1944. [295]

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[Title of Circuit Court of Appeals and Cause.]

#### STATEMENT OF POINTS RELIED UPON

Now comes Barnhart-Morrow Consolidated, the petitioner on review herein, and hereby asserts the following errors upon which it intends to rely in this review:

(1) The Court erred in holding and deciding that petitioner was not insolvent, within the meaning of Section 14(d)(2) of the Revenue Act of 1936, at any time during the year 1936.

(2) The Court erred in holding and deciding

that the evidence was insufficient to show petitioner's right under Sections 14(a) (2) and 26 (c) (3) of the Revenue Act of 1936, as amended by Section 501(a) of the Revenue Act of 1942, to deduct its deficit in accumulated earnings and profits as of December 31, 1935, in determining undistributed net income for the year 1936.

(3) The Court erred in failing to make findings of fact with respect to petitioner's asserted right to the deduction referred to in the preceding assignment. [296]

(4) The Court erred in denying petitioner a rehearing for the purpose of proving its right to the deduction referred to in paragraph (2) of these assignments.

(5) The Court erred in holding and deciding that petitioner was not entitled, in determining its net income and undistributed net income for the year 1936, to deduct \$11,908.53 paid in 1936 as receivership expenses.

(6) The Court erred in holding and deciding that petitioner was not entitled, in determining its net income and undistributed net income for the year 1937, to deduct the loss sustained upon relinquishment of its one-half interest in Well No. 16.

(7) The Court erred in redetermining a deficiency of \$14,509.17 in petitioner's income tax and undistributed profits surtax for the calendar year 1936.

(8) The Court erred in upholding respondent's determination of a deficiency of \$15,816.89 in pe-

titioner's income tax and undistributed profits sur-tax for the calendar year 1937.

HAROLD C. MORTON

LEON B. BROWN

By /s/ LEON B. BROWN

Attorneys for Petitioner

1126 Pacific Mutual Bldg.

Los Angeles 14, California

[297]

Service of a copy of the within statement of points is hereby admitted this 16th day of May, 1944.

J. P. WENCHEL

Chief Counsel,

Bureau of Internal Revenue

By J. P. WENCHEL

C.A.R.

Counsel for Respondent on

Review

[Endorsed]: T.C.U.S. Filed May 16, 1944. [298]

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[Title of Circuit Court of Appeals and Cause.]

PETITIONER'S DESIGNATION OF PORTIONS OF RECORD TO BE INCLUDED IN THE RECORD ON REVIEW

To the Clerk of the Tax Court of the United States:

You will please prepare, transmit, and deliver to the Clerk of the United States Circuit Court of Appeals for the Ninth Circuit, copies, duly certified

as correct, of the following documents and records in the above-entitled cause, for use in connection with the petition for review heretofore filed by Barnhart-Morrow Consolidated:

1. Docket entries of all proceedings before the United States Board of Tax Appeals and the Tax Court of the United States;
2. Petition of Barnhart-Morrow Consolidated, including all exhibits thereto;
3. Answer of Commissioner of Internal Revenue;
4. Stipulation of Facts;
5. Transcript of proceedings and testimony at hearing on October 4, 1941; [299]
6. Petitioner's Exhibits 47, 51, 57, 58, 59, 60, and 61, and the following portions of the cross-complaint admitted as petitioner's Exhibit 41: the title of the court and cause, the two introductory paragraphs, paragraphs IX, XVII and XX, the introductory paragraph of the prayer, and paragraphs 3, 7, 8, and 9 of said prayer;
7. Findings of fact and opinion promulgated August 20, 1942;
8. Petitioner's motion for reconsideration or rehearing and for additional findings, filed September 17, 1942, together with appendices attached;
9. Order dated December 4, 1942;
10. Petitioner's computation filed March 26, 1943;
11. Transcript of proceedings and testimony at hearing on May 5, 1943;
12. Order dated July 30, 1943;

13. Petitioner's recomputation filed on or about January 1, 1944;
14. Decision entered January 24, 1944;
15. Petitioner's motion to vacate decision and for rehearing, together with exhibits attached;
16. Order dated February 29, 1944;
17. Petition for review, with proof of service of copy of petition and of notice of filing same;
18. Petitioner's designation of portions of record to be included in the record on review; [300]
19. Petitioner's statement of points relied upon.  
Said transcript is to be prepared, certified, and transmitted as required by law and the rules of the United States Circuit Court of Appeals for the Ninth Circuit.

HAROLD C. MORTON  
LEON B. BROWN  
By /s/ LEON B. BROWN  
Attorneys for Petitioner  
on Review  
1126 Pacific Mutual  
Building  
Los Angeles 14, California

Service of a copy of the within designation is hereby acknowledged this 16th day of May, 1944.

J. P. WENCHEL  
Chief Counsel, Bureau of Internal Revenue  
By J. P. WENCHEL  
C.A.R.  
Counsel for Respondent on  
Review

[Endorsed]: T.C.U.S. Filed May 16, 1944. [301]

The Tax Court of the United States  
Washington

Docket No. 105859

BARNHART-MORROW CONSOLIDATED,  
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent.

CERTIFICATE OF CLERK

I, B. D. Gamble, clerk of The Tax Court of the United States do hereby certify that the foregoing pages, 1 to 301, inclusive, contain and are a true copy of the transcript of record, papers, and proceedings on file and of record in my office as called for by the Praeclipe in the appeal (or appeals) as above numbered and entitled.

In testimony whereof, I hereunto set my hand and affix the seal of The Tax Court of the United States, at Washington, in the District of Columbia, this 31st day of May, 1944.

[Seal]            B. D. GAMBLE, Clerk,  
                      The Tax Court of the United  
                      States.

[Endorsed]: No. 10806. United States Circuit Court of Appeals for the Ninth Circuit. Barnhart-Morrow Consolidated, a corporation, Petitioner, vs. Commissioner of Internal Revenue, Respondent. Transcript of the Record. Upon Petition to Review a Decision of The Tax Court of the United States.

Filed June 19, 1944.

PAUL P. O'BRIEN

Clerk of the United States Circuit Court of Appeals  
for the Ninth Circuit.

No. 10806

IN THE

United States Circuit Court of Appeals  
FOR THE NINTH CIRCUIT

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BARNETT-MORROW CONSOLIDATED,

*Petitioner,*

*vs.*

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

---

OPENING BRIEF OF PETITIONER.

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HAROLD C. MORTON,  
1126 Pacific Mutual Building, Los Angeles 14,

LEON B. BROWN,  
1212 Pacific Finance Building, Los Angeles 14,

*Attorneys for Petitioner.*

FILED

SEP 23 1944



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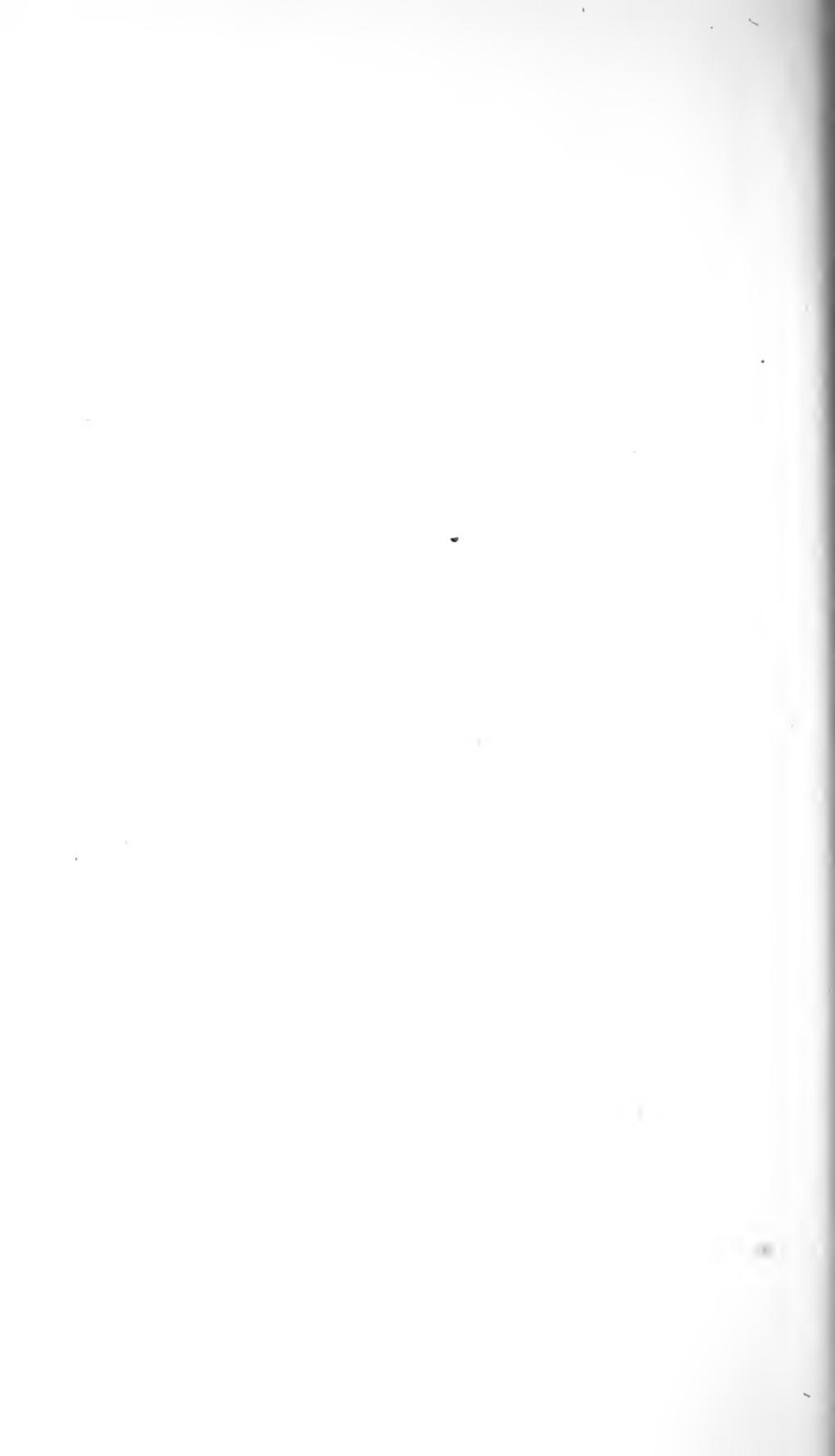
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No. 10806

IN THE

# United States Circuit Court of Appeals FOR THE NINTH CIRCUIT

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BARNHART-MORROW CONSOLIDATED,  
*Petitioner,*

*vs.*

COMMISSIONER OF INTERNAL REVENUE,  
*Respondent.*

---

## OPENING BRIEF OF PETITIONER.

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### Introduction.

This is a proceeding for review of a decision of the Board of Tax Appeals (47 B. T. A. 590) and of an order of The Tax Court of the United States refusing to vacate said decision and grant a rehearing. The parenthetical references set forth in this brief are to the pages of the printed transcript of record.

### Statement of Basis of Jurisdiction.

The jurisdiction of the Board of Tax Appeals (the name of which was changed by Section 504(a) of the Revenue Act of 1942 to "The Tax Court of the United States") is based upon Sections 1101 and 272(a) of the Internal Revenue Code. The jurisdictional facts are alleged in the petition [R. 5-6] and are admitted in the answer [R. 53].

The jurisdiction of this Honorable Court is based upon Sections 1141(a) and 1142 of the Internal Revenue Code. The decision of the Tax Court was entered on January 24, 1944, and the order denying petitioner's motion to vacate the decision and for a rehearing was filed February 29, 1944 [R. 4]. The taxpayer's petition for review was filed May 15, 1944 [R. 5].

The venue is determined by Section 1141(b)(1) of the Internal Revenue Code and the allegation in the petition for review [R. 301] that the taxpayer's returns were filed with the Collector of Internal Revenue for the Sixth District of California.

#### **Statement of the Case.**

Petitioner is a California corporation engaged in the production of oil and gas. In 1927 it acquired by assignment the right to operate certain oil wells in the Santa Fe Springs Field known as wells Nos. 1, 2, 3, 11 and 12 [R. 186-7]. Well No. 12 was abandoned the same year [R. 68]. On September 28, 1928, petitioner acquired a leasehold interest in certain land on which it drilled a productive well known as well No. 16 [R. 187-8]. And in 1930, petitioner entered into an agreement pursuant to which it placed on production a well on adjacent premises known as well No. 17 [R. 189].

In January, 1931, while petitioner was operating the said wells Nos. 1, 2, 3, 11, 16 and 17, an action was instituted in the Superior Court of the State of California entitled *Julian v. Schwartz*. Petitioner was made a party to said action by cross-complaints in which the defendant and certain other persons claimed to be the owners of the said six wells and of all production therefrom [R. 190]. On March 19, 1931, the court in said action appointed two

individuals as receivers to operate the wells and impound the net proceeds of production, and on March 23, 1932, the court appointed two trustees to take over the duties of these receivers. The litigation was finally terminated, favorably to petitioner, on October 28, 1936 [R. 190-191].

On July 29, 1931, an action was filed in the Superior Court of the State of California by one D. R. Morrow, seeking, among other things, an accounting of the affairs of petitioner, and on the same day the said court appointed Ralph S. Armour as receiver for petitioner [R. 191-2]. This appointment did not disturb the possession of the wells by the receivers and trustees appointed in the case of *Julian v. Schwartz* [R. 194].

During the calendar year 1935 petitioner sustained a loss of \$6,063.64 [R. 193], and Exhibit 51 [R. 104], a schedule of balance sheets according to petitioner's books [R. 83], shows that at the end of that year petitioner had a deficit of \$172,161.65. The financial condition of petitioner remained about the same until November, 1936, when petitioner received from the trustees the impounded proceeds of production [R. 195-6].

It was agreed by representatives of the Treasury Department and of the trustees in charge of the wells that no income tax liability should be imposed upon the trustees, but that funds distributed by the trustees should be taxed to the recipients for the years in which the distributions were made [R. 80-81]. However, gas revenues produced by wells Nos. 1, 2, 3 and 11 were released by the trustees in 1933 and subsequent years and were treated as constructively received in those years by petitioner. In determining petitioner's net income for those years, receivership expenses were allowed as deductions for the

years in which they were approved by the court which appointed the receiver [R. 84-5, 196].

On November 12, 1936, the receiver, Ralph S. Armour, filed an account showing additional receivership expenses of \$17,852.12. The court approved the account the same day and directed payment of such expenses out of the first moneys accruing to petitioner [R. 197-8]. On November 14, 1936, the trustees delivered possession of the wells to petitioner, and during said month the trustees paid \$112,000.00 to petitioner and the said sum of \$17,852.13 to said Ralph S. Armour [R. 198].

It was determined in the case of *Julian v. Schwartz* that petitioner and one J. A. Smith were each entitled to a one-half interest in well No. 16 [R. 190-191]. Petitioner had been operating this well at a loss when, in 1937, it ceased producing entirely. The cost of making necessary repairs could not be determined in advance [R. 199]. Although the well had some salvage value, probably \$2,000, it would have cost petitioner between \$5,000 and \$10,000 to plug the well as required by the laws of the state. Accordingly, petitioner, in December, 1937, quit-claimed its interest in the well to said J. A. Smith [R. 199-200], and claimed as a loss the book value of the interest so surrendered.

#### Specification of Errors Relied Upon.

(1) The Tax Court erred in holding and deciding that petitioner was not insolvent, within the meaning of Section 14(d)(2) of the Revenue Act of 1936, at any time during the year 1936.

(2) The court erred in holding and deciding that the evidence was insufficient to show petitioner's right under

Sections 14(a)(2) and 26(c)(3) of the Revenue Act of 1936, as amended by Section 501(a) of the Revenue Act of 1942, to deduct its deficit in accumulated earnings and profits as of December 31, 1935, in determining undistributed net income for the year 1936.

(3) The court erred in failing to make findings of fact with respect to petitioner's asserted right to the deduction referred to in paragraph (2) above.

(4) The court erred in denying petitioner a rehearing for the purpose of proving its right to the deduction referred to in paragraph (2) above.

(5) The court erred in holding and deciding that petitioner was not entitled, in determining its net income and undistributed net income for the year 1936, to deduct \$11,908.53 of the \$17,852.12 paid in 1936 as receivership expenses.

(6) The court erred in holding and deciding that petitioner was not entitled, in determining its net income and undistributed net income for the year 1937, to deduct the loss sustained upon relinquishment of its one-half interest in well No. 16.

(7) The court erred in redetermining a deficiency of \$14,509.17 in petitioner's income tax and undistributed profits surtax for the calendar year 1936.

(8) The court erred in upholding respondent's determination of a deficiency of \$15,816.89 in petitioner's income tax and undistributed profits surtax for the calendar year 1937.

## ARGUMENT.

### I.

During the Year 1936 Petitioner Was Insolvent Within the Meaning of Section 14(d)(2) of the Revenue Act of 1936.

Section 14(d) of the Revenue Act of 1936 provides in part as follows:

“(d) Exemption From Surtax.—The following corporations shall not be subject to the surtax imposed by this section:

\* \* \* \* \*

“(2) Domestic corporations which for any portion of the taxable year are in bankruptcy under the laws of the United States, or are insolvent and in receivership in any court of the United States or of any State, Territory, or the District of Columbia.”

It is undisputed that during the first ten months of 1936 petitioner was in receivership. And there is no question as to the test of insolvency under Section 14(d)(2), it having been settled by the decision of this Honorable Court in *Artesian Water Co. v. Commissioner*, 125 F. (2d) 17, that the taxpayer is insolvent if unable “to meet its obligations as they matured, in the usual course of trade or business.” The issue before the Tax Court, and now on review, is whether or not petitioner, early in 1936, was insolvent by this test.

It should be observed at this point that insolvency at any time during 1936 is sufficient to entitle petitioner to

the exemption claimed. As stated in *United States v. Anderson Co.* (C. C. A. 7), 119 F. (2d) 343, 345:

“. . . no tax is due if the taxpaying corporation in receivership ‘is insolvent for one day of said taxable year.’”

Let us examine the evidence as to the financial condition of petitioner on January 1, 1936. In the year 1931 petitioner had sustained a net loss of \$90,116.67, and the years 1932-1935, inclusive, had brought additional losses of over \$13,000.00 [R. 193]. Petitioner’s balance sheet as of December 31, 1935, showed a deficit of \$172,161.65 [R. 195]. For almost five years all of the capital assets shown on the balance sheet (with the exception of office furniture carried at \$811.50) had been in the possession of receivers and trustees appointed in the case of *Julian v. Schwartz*, and, as the court found [R. 195], “were being claimed by Schwartz and the holders of participating oil agreements as asserted in the proceeding.” Had Schwartz and the holders of participating oil agreements prevailed in the litigation, petitioner would have been hopelessly bankrupt, for not only were they claiming the oil wells as their own, but they were also asserting an obligation on the part of petitioner to account for past production [R. 98-99].

The admitted liabilities of petitioner on December 31, 1935, disclosed by its balance sheet, amounted to \$43,-789.66. These liabilities had not been materially reduced in the past five years [R. 104]. They consisted of notes payable in the amount of \$3,000.00 (unchanged during 1935), accounts payable in the amount of \$17,267.70 (substantially the same as during the preceding two years), \$1,396.68 accrued interest, \$1,051.66 accrued taxes, ac-

crued payroll of \$14,078.00 (unchanged for two years), and \$6,995.63 due to stockholders.

The Tax Court, in its opinion [R. 206], says that the record does not disclose whether any of these debts (except accrued salary of \$14,000.00) "matured during the receivership." The fact that they were matured obligations, however, is evident from the classifications of the balance sheet, Exhibit 51 [R. 104]. These classifications, "Notes *payable*," "Accounts *payable*," "*Accrued expenses*," and "Due to Stockholders," are a sufficient *prima facie* showing that the liabilities listed were neither contingent nor unmatured. There is no evidence to the contrary, and the sufficiency of the showing made by petitioner was never questioned by counsel for the Commissioner.

The true basis, however, of the Tax Court's decision that petitioner was not insolvent on January 1, 1936, is its misunderstanding of one item in Exhibit 51. Listed in the balance sheet as of December 31, 1935, under the heading "Other Assets," is "Capital stock issued for services and leases" in the amount of \$219,120.50. The Tax Court said [R. 206] :

"\* \* \* No attempt was made to show inability to meet maturing debts by a reasonable use of credit. It is true that the oil and gas properties were in the possession and control of the trustees and for that reason could not have been used by the receiver as collateral for a loan, but he had under his control stock of a book value of about \$220,000. Nothing of record is opposed to the idea that this stock could have

been used as security for a loan or sold to pay debts. Neither does it appear that an application was ever made to the court for permission to sell receiver's certificates or otherwise raise funds to meet matured obligations."

When this opinion was promulgated petitioner at once moved for a reconsideration, pointing out [R. 229-230] that the capital stock referred to by the court was not an investment in stocks of other corporations, but was a mere bookkeeping debit item, representing that portion of the Capital Stock item of \$694,977.00, listed as a liability, which represented shares of petitioner issued to promoters for services and leases. In other words, the \$219,120.50 represented stock of *petitioner* issued to *others*.

As stated in Paton's *Accountants' Handbook*, Third Edition, pages 36, 40, 128 and 844, in the application of accounting principles to financial statements a logical arrangement of the assets and liabilities may follow either of two sequences: (1) in order of liquidity, or (2) in the inverse order of liquidity. Intangibles are usually listed as the last or next to the last item on the asset side and should invariably be listed separately. Some of the principal intangible items are (1) purchased good will, (2) patents, franchises, copyrights, etc., (3) long term prepayments or deferred charges, and (4) organization costs. In organizing a corporate enterprise substantial expenditures are often required to cover services of promotion and incorporation and the activities involved in raising capital.

The balance sheet [R. 103] followed the accepted principle of arranging and presenting the assets in order of liquidity, the intangibles separately and next to the last group of accounts. The intangible asset of "Capital stock

issued for services and leases" was listed with other intangible assets of the company. As the words themselves imply, the stock was *issued* by the company and not received by it through purchase as an investment. Furthermore, if the item had been an investment in stocks of other companies, then, in accordance with accepted principles of accounting, the item would have *preceded* the caption "Capital Assets" on the balance sheet.

In other words, "Capital stock issued for services and leases" is a phrase intended to describe the transaction through which intangible promotional benefits were received by petitioner. These benefits, of course, have no realizable value.

We believe the Tax Court should have paused to reflect that if petitioner had possessed a marketable asset worth anything like \$219,120.50, the court which appointed the receiver would long before have ordered a sale of this asset to pay liabilities. The receiver's final account showed that even receivership expenses had remained unpaid for many years [R. 197.] Finally, the Tax Court should have realized that counsel for the Commissioner would have pointed out an asset worth \$219,120.50 if it actually existed.

This glaring error was called to the attention of the Tax Court by motion for reconsideration. Attached to the motion was the affidavit of George F. Meitner, petitioner's auditor, stating:

"that the item on Petitioner's Balance Sheet, Exhibit No. 51, 'Capital Stock Issued for Services and Leases \$219,120.50,' referred to stock issued by Petitioner to others for services and leases, and was simply an intangible item of no value, being what is commonly called 'promotion stock.' "

Certain other errors were corrected by supplemental orders [R. 244-5, 270-72]; yet the statement was allowed to remain in the opinion that petitioner possessed capital stock of a book value of almost \$220,000, and the motion for reconsideration was denied.

Exhibit 51 was not the only evidence of petitioner's insolvency at the beginning of 1936. *The testimony of petitioner's attorney stands undisputed that until the funds impounded by the trustees appointed in the case of Julian v. Schwartz were released, petitioner was without funds to pay its obligations or conduct its affairs* [R. 119-120].

Let us see, now, whether petitioner could under the circumstances have raised such funds by borrowing on its assets or by the issuance of receiver's certificates, as suggested by the court. Its accounts receivable, listed at \$35,507.19, are described in the balance sheet, Exhibit 51, by the phrase "collection and realization on which will exceed one year." Of the total, \$7,104.61 due from C. C. Julian remained constant for five years, and the court found [R. 191] that he died in 1934, leaving no estate. The next item, \$21,978.09 due from "W. J. Barnhart and/or East Santa Fe Springs Escrow Account," remained constant during the years 1933, 1934 and 1935 and was definitely not an asset upon which anything could be realized. Nothing had been collected on Sundry Accounts of \$296.31 since 1931. The amount receivable from the Texas Co. represented, as stated in the exhibit, gas revenues withheld. It would, of course, depend upon the outcome of the litigation in *Julian v. Schwartz* whether

petitioner or others were entitled to these revenues. Finally, the item of \$4,518.22 shown as due from J. A. Smith is explained by the statement "Contra against indebtedness due him" and was thus not collectible.

The California superior court's order of November 12, 1936, terminating the receivership, recited the fact that petitioner was "no longer insolvent, by reason of its success in the litigation entitled Julian v. Schwartz" [R. 198]. The Tax Court said that this statement was not helpful because insolvency was not the ground for the receivership, and that "inability to pay due to impounding of assets in a receivership, not based upon grounds of insolvency, is not proof of insolvency in the sense of inability to meet maturing debts." This statement was directly contrary to the decision of this Court in *Artesian Water Co. v. Commissioner, supra*, where we find the following:

"The Commissioner in his brief divides his argument upon this phase of the case into two subdivisions. First it is urged that 'the receivership intended by this section was obviously intended to mean one caused by financial difficulties and not one arising from disputes between the stockholders, charges of mismanagement, failure to obey the laws, etc.' We do not agree. There is nothing in the statute or in the authorities to our knowledge that provides that in order to fall within the terms of the statute a corporation must be in receivership because of its insolvent condition. So far as the statute provides, it is enough if the corporation is insolvent and in re-

ceivership, and the nature of the receivership proceeding is immaterial.

\* \* \* \* \*

"It is certain, of course, that the taxpayer was not insolvent in a bankruptcy sense of having liabilities exceeding assets. As stated above, its assets exceeded one million dollars, and its liabilities were less than one hundred and fifty thousand dollars. We are unable to agree with the apparent holding of the Board that a corporation must be insolvent within this sense of the word in order to be entitled to exemption. See United States v. Anderson Co., 7 Cir., 119 F. 2d 343, 346, and authorities therein cited.

"It follows, then, that if the finding of solvency is to be affirmed, it must be on the basis that the taxpayer was able to meet its obligations as they matured, in the usual course of trade or business. We find no support in the record for such a finding. It is clear that the notes to the Pacific Mutual Life Insurance Company became due after the 'informal extension,' in the year 1937, the tax year in question. It is equally clear that the taxpayer was unable to meet this obligation at its maturity, either from its current assets or with 'the reasonable use of the debtor's credit.' United States v. Anderson Co., *supra*. As stated above, all of the taxpayer's income bearing assets were pledged to the Insurance Company as security for the loans, and in view of the receivership taxpayer's hands were just as effectively tied as if it had been in bankruptcy. As well put by the taxpayer in its brief, 'The solvency or insolvency

of the petitioner, that is, its ability to pay its debts, must be determined in the actual situation in which the petitioner is found in the taxable year, and not in some false and assumed situation in which it is not found, for example, free from receivership.’”

In the present case petitioner was unable to pay its matured debts, not because of the receivership, but because of other litigation in which the title to substantially all its assets and the income derived therefrom was claimed by other persons. The trustees appointed in the case of *Julian v. Schwartz* were mere stakeholders, without power except to operate the wells and impound the net proceeds of production until the rightful owners should be determined by the court. During the pendency of the litigation it is clear that these assets were not available for the payment of petitioner's debts.

It therefore appears that during the early part of 1936 petitioner had matured liabilities which had remained constant for several years and that it was entirely without funds and without access to assets from which funds could be realized. It is submitted that during the period in question petitioner was clearly unable to meet its matured obligations and was therefore insolvent within the meaning of Section 14(d)(2).

If, however, there was any deficiency in proof of insolvency, petitioner should have been given an opportunity to supply the necessary additional evidence. The authorities which support petitioner's right to this further opportunity are set forth at a later point in this brief.

II.

Petitioner Was Entitled, in Computing Its Undistributed Net Income for 1936, to Deduct Its Deficit as of December 31, 1935.

The opinion of the Tax Court in this case was promulgated on August 20, 1942. Section 501(a) of the Revenue Act of 1942, which became law on October 21, 1942, retroactively amended Section 14(a)(2) of the Revenue Act of 1936 to read as follows:

“The term ‘undistributed net income’ means the adjusted net income minus the sum of (A) the dividend paid credit provided in section 27, (B) the credit provided in section 26(c) relating to restrictions on payment of dividends, (C) except in cases where section 26(c)(1) is applicable, the deficit credit provided in section 26(f), and (D) the redemption credit provided in section 26(g).”

and retroactively added to the Revenue Act of 1936 Section 26(c)(3), reading as follows:

“In the case of a corporation having a deficit in accumulated earnings and profits as of the close of the preceding taxable year, the amount of such deficit, if the corporation is prohibited by a provision of a law or of an order of a public regulatory body from paying dividends during the existence of a deficit in accumulated earnings and profits, and if such provision was in effect prior to May 1, 1936.”

These amendments were made applicable to the instant case by Section 346 of the Civil Code of the State of California, as amended in 1933, reading as follows:

“A corporation may declare dividends payable in cash or in property only as follows:

“(1) Out of earned surplus; or

“(2) Despite the fact that the net assets of the corporation amount to less than the stated capital, out of net profits earned during the preceding accounting period which shall not be less than six months nor more than one year in duration; or

“(3) Out of paid-in surplus or surplus arising from reduction of stated capital subject to the provisions of section 348b, Civil Code, only upon shares entitled to preferential dividends; provided that notice shall be given to the shareholders receiving such dividends of the source thereof prior to or concurrently with the payment thereof.

*“Impaired assets.* If the value of the net assets amounts to less, through depreciation, depletion, losses, or otherwise, than the aggregate amount of stated capital attributed to shares having liquidation preferences, the corporation shall not declare dividends out of net profits pursuant to subdivision (2) of this section, except upon such shares, until the value of the net assets has been restored to such aggregate amount of the stated capital attributed to outstanding shares having liquidation preferences.

*“Dividends.* No dividends shall be declared when there is reasonable ground for believing that thereupon the corporation’s debts and liabilities would exceed its assets or that it would be unable to meet its debts and liabilities as they mature.

“No dividends shall be declared out of the mere appreciation in the value of its assets not yet realized, nor shall any dividends be declared from earned surplus representing profits derived from an exchange of assets unless and until such profits have been realized or unless the assets received are currently realizable in cash.

“*Wasting asset corporation.* A wasting asset corporation, that is a corporation engaged solely or substantially in the exploitation of mines, oil wells, gas wells, patents or other wasting assets, or organized solely or substantially to liquidate specific assets, may distribute the net income derived from the exploitation of such wasting assets or the net proceeds derived from such liquidation without making any deduction or allowance for the depletion of such assets incidental to the lapse of time, consumption, liquidation or exploitation; subject, however, to adequate provision for meeting debts and liabilities and the liquidation preferences of outstanding shares and to notice to shareholders that no deduction or allowance has been made for such depletion.”

That Section 346 of the California Civil Code is such a law as is contemplated by Section 501(a) of the Revenue Act of 1942 was recognized by the Tax Court in *Signal Oil Company v. Commissioner*, 2 T. C. 90, 96 (Commissioner's acquiescence noted C. B. 1943, p. 20).

Petitioner had no right to declare dividends in 1936 under sub-paragraph (2) of Section 346, for during its preceding accounting period it sustained a net loss of \$6,063.64 [R. 193]. It was therefore prohibited by Section 346 from declaring dividends until such time as it might have a capital surplus. Petitioner's balance sheet as of December 31, 1935, showed a deficit of \$172,161.65, and it claims the right, under the retroactive amendment, to deduct this sum in computing its undistributed net income for 1936. The effect, of course, would be to eliminate entirely any surtax on undistributed profits for that year.

The 1942 amendments to the Revenue Act of 1936 became effective after the submission to the Tax Court in this case of petitioner's motion for reconsideration or rehearing, but were called to the attention of the court in petitioner's computation for entry of decision, filed March 26, 1943 [R. 252-4], and at the hearing under Rule 50 on May 5, 1943. At this hearing, as stated in the Tax Court's order of February 29, 1944 [R. 297-8], petitioner submitted its contention that it was entitled to a deficit credit upon the facts already in the record, but only because the court advised counsel for petitioner that new evidence could not be considered at a hearing under Rule 50. Mr. Meitner, appearing for petitioner, was of the opinion that the deficit shown on Exhibit 51 might have to be recomputed by substituting cost depletion for percentage depletion, in the same manner as required for determining the source of distributions under Section 115 (see Reg. 111, Sec. 29.115-6). He stated, however, that he did not believe this recomputation would affect the amount of the deficit shown on Exhibit 51 [R. 262]. The court then said [R. 262-3] :

“We don't like to try these cases upon recomputation. . . . Now, it is obvious that there is a real reason for not bringing in new facts, new proof, new evidence, upon a recomputation. I don't think that that should be considered upon this recomputation at all; that I should hear you on new evidence. But I am not saying that perhaps you might be allowed to file a motion for reconsideration, to set up such new facts if you show proper grounds for doing so.”

Mr. Meitner then called attention to the deficit of \$172,-161.65 as of December 31, 1935, shown on Exhibit 51, Part 2, and explained [R. 264] :

"I am not proposing any new evidence unless the court deems it proper, if new evidence is necessary to sustain that figure. In other words, not now."

It is clear that counsel was merely abiding by the court's ruling that new evidence could not be considered at a hearing under Rule 50 and was not waiving the right to offer such evidence at a later time if it should appear to be necessary.

Then followed the Tax Court's order of July 30, 1943 [R. 270-272], which corrected the figures as to gross income, operating expenses, and net income, and ordered the parties to submit recomputations under Rule 50, but which made no mention of petitioner's claim to a deficit credit. Revised recomputations were then filed, and the application of Section 501 was again presented by petitioner [R. 298]. On January 24, 1944, the court entered its decision [R. 285], in which, again, no mention was made of the new issue. Petitioner then filed its motion to vacate the decision and for a rehearing, stating that upon the rehearing it would submit, in support of its claim to the deficit credit, an analysis of the deficit account as of December 31, 1935 [R. 287]. This motion was disposed of by the order of February 29, 1944, in which the court said [R. 299-300] :

"The present motion raises no question not already examined and considered over a long period, and so far as suggestion of new evidence is concerned, comes after petitioner's decision on May 5, 1943, to stand upon the original evidence. The only additional evidence now suggested by motion is an analysis of the

deficit account. Nothing newly discovered, since the hearing on the issue on May 5, 1943, is suggested. The record evidence has, upon the earlier presentations of the question, been found insufficient to show right to the deficit corporation credit. In the light of the entire record here, and after repeated presentation and consideration of this question, no just reason is found to vacate the decision of January 24, 1944, and the petitioner's motion is therefore denied."

Now, it is apparent from the record that this decision was most unjust to the petitioner. The evidence is said to be insufficient to show petitioner's right to the deficit credit, but the court does not explain wherein the evidence is deficient. The court says that the suggestion of new evidence "comes after petitioner's decision on May 5, 1943, to stand upon the original evidence," whereas the record shows, as demonstrated above, that petitioner made no such decision on May 5, 1943, but on the contrary was prevented by the court from offering additional evidence, since the hearing was merely to settle differences in computation under Rule 50. The court then says that the additional evidence suggested is not shown to be newly discovered since the hearing on May 5, 1943. This might be a ground for denying a rehearing if petitioner had had an opportunity on May 5, 1943, to present evidence, but we have shown that petitioner had no such opportunity.

The decision of the court that petitioner was not entitled to a deficit credit in determining its 1936 undistributed net income is not supported by any presumption in favor of the Commissioner's findings, for the right to the deficit credit was created by the Revenue Act of 1942, long after the Commissioner's determination of a deficiency. The presumption of correctness which ordi-

narily attaches to the Commissioner's findings does not apply to issues raised for the first time after the notice of deficiency.

*First Nat. Bank of Boston v. Commissioner of Int. Rev.* (C. C. A. 1), 63 F. 2d 685, 693-4.

Furthermore, the presumption in favor of the Commissioner's determination is merely a procedural device and is not in itself evidence to be weighed against evidence produced by the taxpayer. In *J. M. Perry & Co. v. Commissioner*, 120 F. (2d) 123, 124, this Court said:

"It follows that the Commissioner must have found that the corporation was 'availed of' for that purpose. This finding is presumptively correct, that is, until the taxpayer proceeds with competent and relevant evidence to support his position, the determination of the Commissioner stands. When such evidence has been adduced the issue depends wholly upon the evidence so adduced and the evidence to be adduced by the Commissioner. The Commissioner cannot rely upon his determination as evidence of its correctness either directly or as affecting the burden of proof. *Welch v. Helvering*, 290 U. S. 111, 115, 54 S. Ct. 8, 78 L. Ed. 212; *Helvering v. National Grocery Co.*, 304 U. S. 282, 294, 295, 58 S. Ct. 932, 82 L. Ed. 1346; *Helvering v. Talbott's Estate*, 4 Cir., 1940, 116 F. 2d 160, 162."

Where evidence is produced by the taxpayer alone, it is the duty of the Tax Court to make findings on the basis of such evidence, without regard for any presumption in

favor of the Commissioner's determination. Thus, in *Hemphill Schools v. Commissioner*, 137 F. (2d) 961, 963-4, this Honorable Court remanded the case to the Tax Court, saying:

"The Board's holding that petitioner was availed of for the purpose of preventing the imposition of the surtax upon its shareholders through the medium of permitting gains and profits to accumulate instead of being divided or distributed appears to have been based on respondent's determination that petitioner's gains and profits were permitted to accumulate beyond the reasonable needs of its business. Whether that determination was correct or incorrect was the principal, if not the sole, issue in the case. The burden of proving it incorrect rested on petitioner. Thus, if no evidence had been produced, the Board would have had to accept the determination; for, until evidence was produced, the determination was presumed to be correct.

"Evidence *was* produced. Some of the evidence produced by petitioner tended to prove that its gains and profits were not permitted to accumulate beyond the reasonable needs of its business. Evidence having been so produced, the presumption ceased, and thenceforth the issue depended 'wholly upon the evidence.' It thus became the duty of the Board to find from the evidence, and from it alone, whether petitioner's gains and profits were permitted to accumulate beyond the reasonable needs of its business. No such finding was made. Instead, the Board treated the presumption (which no longer existed) as if it were evidence, weighed it against petitioner's evidence and concluded that petitioner's evidence did not 'overcome' it."

See also *Lawrence v. Commissioner*, decided by this Court on June 13, 1944, in which the Court said:

“The Tax Court also stated in its opinion that petitioners had failed to overcome the presumption that respondent's determination of their tax liability was correct. That presumption disappears when, as here, evidence is introduced which would be sufficient to sustain a contrary finding (*Wiget v. Becker*, 84 F. 2d 706, 707-8; *Co-operative Publishing Co. v. C. I. R.* (9 Cir.), 115 F. 2d 1017, 1021-2; *cf. New York Life Ins. Co. v. Gamer*, 303 U. S. 161, 171).”

Here the only evidence before the Tax Court was Petitioner's Exhibit 51, Part 2 [R. 104], showing a deficit of \$172,161.65 as of December 31, 1935, and the stipulation of counsel that Exhibit 51 was a schedule showing balance sheets as per petitioner's books [R. 83]. This was certainly evidence tending to prove a deficit in accumulated earnings and profits in the stated amount. Of course, circumstances can be imagined which might affect the weight to be given the balance sheet as evidence of accumulated operating losses (although *Byron Sash & Door Co. v. United States* (D. C., Ky.), decided April 10, 1944, holds that no adjustment of the balance sheet deficit is required even for prior capitalization of earned surplus); but no evidence of any such circumstance was presented to the Tax Court. It is submitted that the balance sheet was *prima facie* evidence which, standing uncontested, required a finding in favor of petitioner.

The Tax Court did not even attempt to make a finding as to whether or not petitioner had “a deficit in accumulated earnings and profits as of the close of the preceding taxable year.” This, in itself, would require that the case be remanded, for it is not a function of the Circuit Courts

of Appeals to make findings of fact. In *Bell v. Commissioner* (C. C. A. 3), 139 Fed (2d) 147, it appeared that the taxpayer claimed as a basis for determining gain or loss on the sale of corporate stock the cost of bonds which he had exchanged for the stock in what he claimed was a tax-free reorganization under Section 112(g)(1) of the Revenue Act of 1936. After the Tax Court, on January 19, 1943, had filed its memorandum decision in favor of the Commissioner, the taxpayer presented a motion for reconsideration on the ground that the exchange was a tax-free transfer to a controlled corporation, within the meaning of Section 112(b)(5) as construed by the Supreme Court in *Helvering v. Cement Investors, Inc.*, a case decided June 1, 1942. The Circuit Court of Appeals said (pages 148-9) :

“It is also true that neither party brought that provision of the Revenue Act or the Supreme Court’s construction thereof in the Cement Investors case to the attention of the Tax Court prior to its decision. However, the petitioner did move timely for a reconsideration of the Tax Court’s decision and specified as the reason for his motion the pertinency of Sec. 112(b)(5). In that way the point now advanced by the petitioner was raised below; and the Tax Court terminated the matter by entering an order denying the petitioner’s motion for a reconsideration of the decision.

\* \* \* \* \*

“In the Cement Investors case it was undisputed (see 316 U. S. at page 531, 62 S. Ct. at page 1127, 86 L. Ed. 1649) that ‘the stock and income bonds acquired by each bondholder were substantially in proportion to his interest in the assets of the debtor companies prior to the exchange.’ In the instant case

there has been no finding in such regard. In view of the statute's cognate requirement, the necessity for an appropriate finding in material connection is readily apparent. Each party has presented argument in support of his respective contention as to what the relevant finding should be on the basis of the record facts. But it is no part of our province, upon the review of a decision by the Tax Court, to make fact findings. That duty devolves upon the authorized fact finder. We have naught to do therefore but to remand the case to the Tax Court for a finding with respect to the material fact indicated and for decision thereafter in the light of the findings as they then exist."

It is submitted that, in the light of the evidence that petitioner had a deficit as of December 31, 1935, the Tax Court erred in deciding, without even making a finding as to the existence or non-existence of a deficit in accumulated earnings as of the close of the preceding year, that there was a deficiency in surtax on undistributed profits for the year 1936. But, erroneous as was this decision, much more arbitrary and erroneous was the refusal of the court on February 29, 1944, to allow petitioner a rehearing for the purpose of presenting additional evidence in support of its claim to a deficit credit. The Tax Court should have been willing, in the interests of justice, to determine whether or not petitioner was entitled to the benefit of the retroactive amendments made by Section 501(a) of the 1942 Act. Instead, the court sought plausible excuses for denying petitioner the opportunity to present the facts. Under such circumstances an appeal to a higher court of justice should never be unavailing.

Nor have such appeals been unavailing in the past. In *Chatham Phoenix Nat. Bank & Trust Co. v. Helvering*

(C. C. A., D. C.), 87 F. (2d) 547, 549-50, the Circuit Court of Appeals for the District of Columbia said:

"We realize that the burden was upon the taxpayer to prove its case, and that it failed to introduce sufficient evidence in this respect, but we are here confronted with a case wherein it is perfectly clear that, by reason of the unauthorized action of Brady in attempting to appear as a representative of the taxpayer (for which, as we gather from the record, the Board punished him by disbarment from further practicing before it), there was really no hearing according to law, and in which it appears that there may be a valid claim on the part of the taxpayer for a refund of the tax paid. We think, under these circumstances, that a hard and fast rule should not be applied, the result of which may be to enrich the government unjustly and punish the taxpayer.

"The taxpayer appeals from both the division member's order of December 21, 1934, denying a retrial, and the decision of the Board refusing to review the order of December 21, 1934. As to the order of December 21, 1934, neither the applicable statutes nor the rules of practice adopted by the Board of Tax Appeals deal specifically with motions for rehearing. It has been held, however, that the Board has power to grant a rehearing, Helvering v. Continental Oil Co., 63 App. D. C. 5, 8, 68 F. (2d) 750; Burnet v. Lexington Ice & Coal Co. (C. C. A.), 62 F. (2d) 906, 908; Garden City Feeder Co. v. Commissioner of Internal Revenue, 27 B. T. A. 1132, and, further, that the granting of a rehearing lies within the sound discretion of the Board, Bankers' Pocahontas Coal Co. v. Burnet, 287 U. S. 308, 313, 53 S. Ct. 150, 151, 77 L. Ed. 325. Undoubtedly the court has jurisdiction to determine whether, under all the circumstances, that discretion has been abused.

“But the power of this court to order a rehearing of the case does not extend only to the abuse of discretion on the part of the Board. This power may be exercised when necessary to meet the ends of substantial justice. This court has the power under the statute to modify or reverse the decision of the Board, if not in accordance with law, ‘as justice may require.’ 44 Stat. 110, section 641 (c), T. 26 U. S. C., 26 U. S. C. A. Sec. 641 (c). The cases disclose numerous instances where this broad power has been exercised. Dempster Mill Mfg. Co. v. Burnet, 60 App. D. C. 23, 46 F. (2d) 604; L. J. Christopher Co. v. Commissioner of Internal Revenue, 60 App. D. C. 368, 370, 55 F. (2d) 530; Underwood v. Commissioner of Internal Revenue (C. C. A.), 56 F. (2d) 67, 73; Virginia-Lincoln Furniture Corp. v. Commissioner of Internal Revenue (C. C. A.), 56 F. (2d) 1028, 1033; Helvering v. Edison Securities Corp. (C. C. A.), 78 F. (2d) 85, 91, 92; Fritz v. Commissioner of Internal Revenue (C. C. A.), 76 F. (2d) 460, 461; Commissioner of Internal Revenue v. Langwell Real Estate Corp. (C. C. A.), 47 F. (2d) 841, 842; Slayton v. Commissioner of Internal Revenue (C. C. A.), 76 F. (2d) 497, 498.

‘In the Virginia-Lincoln Case, *supra*, the court said: ‘In addition to this, it appears from the record that petitioner is entitled to relief; and we will not turn him out of court because he may have misconceived his remedy. As we have said before, courts exist to do justice, not to furnish a forum for the technical skill of counsel. In reviewing a decision of the Board, we are given broad powers to affirm, modify, or reverse it “as justice may require” (26 U. S. C. A., Sec. 1226); and we do not think that justice requires that a petitioner with a meritorious

case be turned out of court upon any such technical ground.'

"In the Fritz Case, *supra*, in considering a petition to review a decision of the Board, the Circuit Court of Appeals for the Fifth Circuit said: 'We should not upset this finding of fact unless the board abused its discretion in refusing to reopen the case for further evidence. We recognize on the one hand that the board has discretion as a *quasi* court touching the reopening of its proceedings. Bankers' Pocohontas Coal Co. v. Burnet, 287 U. S. 308, 309, 53 S. Ct. 150, 77 L. Ed. 325; Weiller v. Commissioner (C. C. A.), 64 F. (2d) 480; Wise & Cooper Co. v. Commissioner (C. C. A.), 53 F. (2d) 843; Washburn Wire Co. v. Commissioner (C. C. A.), 67 F. (2d) 658, 659. And on the other hand our power and responsibility on review extend to the requirement of further trial when error of law, surprise, or arbitrary action makes it proper.'

"Running through all the cases cited is the similar determination of the courts that, where it appears that a further hearing would be promotive of justice, the taxpayer should be given the opportunity of amending his pleadings and of offering evidence to show that he suffers through a wrongful determination of his tax liability."

The same court, in *Ohio Valley Rock Asphalt Co. v. Helvering*, 95 F. (2d) 87, 90, said:

"When to all of this is superadded the fact that after the Board's decision and in apt time petitioner asked leave to produce additional evidence to cover its default in evidence on the point mainly relied on by the Board, and was refused, it seems to us clear that the Board's decision to reject the entire claim is wholly unsustainable. Petitioner, as we think, has

shown that the Commissioner's determination of its tax liability is excessive and that to sustain it would impose upon petitioner the duty of paying a tax that confessedly it does not owe. In similar circumstances the Supreme Court has said that the Board should hold the assessment arbitrary and invalid and should afford the taxpayer an opportunity to show whether a fair apportionment may be made and, if so, the correct amount of the tax. *Helvering v. Taylor*, 293 U. S. 507, 55 S. Ct. 287, 79 L. Ed. 623.

"As we have indicated above, we think there is sufficient evidence in the record on which the Board could have made a reasonable estimate of some, if not all, of the factors upon which depletion is computed. And if it be said that the estimates would be only rough approximations it may be replied, as the Supreme Court said in *United States v. Ludey*, 274 U. S. 295, 47 S. Ct. 608, 71 L. Ed. 1054, that it is better to act upon a rough estimate than to ignore the fact of depletion. In view of petitioner's application for a rehearing and for an opportunity to produce evidence which was not available to it at the former hearing, simple justice requires that petitioner be granted further opportunity to present its proof. We, therefore, remand the cases to the Board with instructions to consider the testimony already taken and such further competent testimony as may be offered, to find the facts, and to determine the correct amount of the assessment on that basis."

We respectfully represent to this Honorable Court that every fact necessary to show petitioner's right to a deficit credit under Section 501(a) of the Revenue Act of 1942 can be established by competent evidence, and we submit that, in the interests of justice, this case should be remanded to the Tax Court with instructions to permit such evidence to be presented.

III.

Petitioner Was Entitled to Deduct Receivership Expenses Paid in 1936 in Determining Its Net Income and Undistributed Net Income for That Year.

The Tax Court found [R. 197-8] that on November 12, 1936, Ralph S. Armour filed with the Superior Court of the State of California his account as receiver showing expenses incurred in the total amount of \$17,852.12, and that on the same day the said court approved the account and directed payment of the said sum out of the first moneys accruing to petitioner. The findings also show that the impounded funds paid by the trustees in 1936 included \$17,852.13 paid to Armour for the account of petitioner [R. 198].

The Commissioner, in his notice of deficiency, had disallowed the deduction of \$11,908.53 of this amount on the ground that expenses in that amount "properly accrued prior to the taxable year" [R. 46]. This disallowance was alleged in the taxpayer's petition to be error [R. 7], and the Commissioner's answer put this allegation in issue [R. 53]. Thereafter, counsel for the parties entered into a stipulation in which it was agreed [R. 83-5] that in determining petitioner's net income or loss for the years 1933, 1934 and 1935, the Treasury Department had allowed deduction of receivership expenses "in and for the years in which they were definitely determined and approved by the Court in said cause of action No. 325061, wherein the said Ralph S. Armour was receiver" [R. 85].

The Tax Court in its findings [R. 196] stated petitioner's income and expenses for the year 1936 and *included among expenses receivership expenses in the sum of*

*\$17,574.68, the amount shown on Petitioner's Exhibit 60.* The record does not explain the discrepancy between this figure and the \$17,852.13 found to have been paid the receiver by the trustees.

Notwithstanding this finding as to petitioner's income and expenses for 1936, the Commissioner, in submitting his computation under Rule 50, deducted only \$5,666.15 as receivership expenses for the year 1936. This was called to the attention of the Tax Court in the computation filed by petitioner on March 26, 1943 [R. 250], and again in its recomputation filed on or about January 1, 1944 [R. 275], but the decision was nevertheless based upon the Commissioner's computation as to receivership expenses deductible. Petitioner thereupon filed its motion to vacate the decision, asserting that in disallowing the additional deduction of \$11,908.53 as receivership expenses, the decision was contrary to the stipulations of counsel and the court's own findings. The motion, as heretofore stated, was denied by order of February 29, 1944, in which the court made only the following mention of the matter of receivership expenses [R. 296-7]:

“All of the matters presented by the present motion had, prior to the filing thereof, been thoroughly considered. On December 4, 1942, motion filed September 17, 1942, for rehearing, including consideration of the issues now raised as to loss on Well No. 16 and insolvency, was denied. The matter of receivership expense was waived at the original hearing, and was not discussed in petitioner's briefs nor at the hearing under Rule 50. *The above issues were nevertheless reconsidered because the figures involved were incorporated in the recomputations submitted.*”  
(Emphasis supplied.)

The court's statement that the matter of receivership expense was waived at the original hearing is based upon the following discussion between the court and counsel at the hearing on October 4, 1941 [R. 108]:

"The Member: Do you have a statement for the respondent?

Mr. Tonjes: There are other issues set forth in the petition, your Honor, and I presume that those are waived.

Mr. Burkhead: That is correct.

#### STATEMENT OF CASE ON BEHALF OF RESPONDENT.

Mr. Tonjes: That leaves five issues as stated by the counsel for petitioner.

I might say briefly what my position is with respect to these several issues.

The Member: First, before you start, you speak about others being waived. I was wondering about that, because there are a large number enumerated here. Are they waived or have some of them been disposed of by your stipulation?

Mr. Burkhead: No. They have been waived. They are small items."

Obviously, counsel for petitioner had completely forgotten the issue as to receivership expenses; but by his statement that the issues waived "are small items" he clearly showed that what he had reference to were the issues raised in subsections (f), (n), (o) and (p) of paragraph 4 of the petition [R. 7, 8], aggregating \$1,991.17 in amount. A waiver is, by definition, the intentional relinquishment of a known right; and certainly counsel for petitioner did not intentionally relinquish its right to a deduction of almost \$12,000.00.

In any event, the question of prior waiver is removed from the case by the fact that the Tax Court, on the motion for rehearing, affirmatively undertook to decide the question as to receivership expenses, and was therefore required to decide the question correctly. In the excerpt from the order of February 29, 1944, above quoted, the court says that

“The above issues were nevertheless reconsidered because the figures involved were incorporated in the recomputation submitted.”

Petitioner's computations are in the record, and it can be seen therefrom that no figures were incorporated with respect to the issue as to loss on well No. 16 or the issue as to insolvency. The only issue concerning which figures *were* incorporated in the computations submitted was the issue as to receivership expenses.

On the merits, it is submitted that the liability for receivership expenses paid in 1936 did not accrue in prior years. A receiver, of course, is an officer of the court, subject to its direction and control. In California the powers of receivers are specified in Section 568 of the Code of Civil Procedure, as follows:

“The receiver has, *under the control of the court*, power to bring and defend actions in his own name, as receiver; to take and keep possession of the property, to receive rents, collect debts, to compound for and compromise the same, to make transfers, and generally to do *such acts respecting the property as the court may authorize.*” (Emphasis supplied.)

Thus, a receiver cannot subject the assets of a corporation to liability without the approval of the court under whose authority he acts. As stated in *Pacific Ry. Co. v. Wade*, 91 Cal. 449, 27 Pac. 768, 770:

“No one claiming a right paramount to that of the receiver can assert it in any action without the permission of the court. No sale can take place, no debt can be paid, no contract can be made, which does not receive the sanction of the court.”

Until the court which appointed Armour as receiver approved his final account on November 12, 1936, and directed payment of the sums therein specified, there was no certainty that petitioner would ever be required to pay any part of the \$17,852.12 for which deduction is now claimed. For this reason, until the order was made, petitioner was not entitled to deduct these receivership expenses as accrued liabilities. The case falls within the familiar rule, restated on February 28, 1944, by the Supreme Court in *Security Flour Mills Co. v. Commissioner*, 320 U. S. ...., 88 L. Ed. (Adv. Op.) 471, as follows:

“It is settled by many decisions that a taxpayer may not accrue an expense the amount of which is unsettled or the liability for which is contingent.”

It is therefore submitted that the Tax Court erred in sustaining the Commissioner in the contention that \$11,908.53 of the \$17,574.68 claimed as a deduction for 1936 represented liabilities accrued in prior years.

IV.

**Petitioner Sufficiently Established the Loss Sustained  
in 1937 on Surrender of Well No. 16.**

The history of well No. 16 is set forth in some detail in the findings of the Board of Tax Appeals [R. 187-9]. The well was a small producer, and it declined in production at the end of 1937 [R. 117]. During 1937, up to December 20th, when the well was quitclaimed to Smith, petitioner had sustained a net loss on this well, before making any deduction for depletion, of \$3,258.78 [R. 152]. Finally the well ceased producing entirely; it had "sanded out" and couldn't be pumped [R. 129]. The operating agreement between petitioner and Smith's predecessor in interest limited the expense chargeable against Smith's interest to one-half of \$500 per month [R. 117], which was not sufficient to operate the well [R. 124], and there was no way of charging Smith with any part of the cost of making necessary repairs [R. 131-2]. Furthermore, it was impossible to know in advance how much repair work would be required [R. 133-4].

The board of directors of petitioner was composed of practical oil men [R. 131]. They held a meeting on December 17, 1937, at which, after full discussion, they adopted a resolution to release, surrender, and quitclaim to Smith petitioner's entire interest in the well [R. 100-1]. Harold C. Morton, one of the directors, testified that he knew at the time that Smith had spent a great deal of money in attempting to return to production two wells located on the same ten-acre tract [R. 118-19]. The directors discussed the possibility of dividing up with Smith as much of the physical equipment as could be salvaged, but under the terms of the lease the lessors had a right to possession of the equipment upon abandonment.

Under all the circumstances, the directors decided to turn everything over to Smith, including the equipment [R. 124-5]. The well went off production on December 17th and was quitclaimed on December 20th [R. 152].

Fortunately for Smith, the repair work necessary to put well No. 16 back on production proved simple and inexpensive. He found the liner crumpled, but not totally collapsed, and the entire cost was only \$700 or \$800. About a year and a half before, while the well was being operated by Smith as a trustee in the case of *Julian v. Schwartz*, the liner did collapse, and it cost between \$18,000 and \$20,000 to accomplish no more than Smith was able to do at the end of 1937 at a very small expense [R. 130-1].

By quitclaiming to Smith, petitioner relieved itself of an onerous liability. Under the terms of its 1928 agreement petitioner was required to operate the well, even at a loss, so long as it retained possession [R. 124, 126]. It undoubtedly chose the course of wisdom in surrendering the well to Smith, for although the well produced over \$15,000 worth of oil in 1938 [R. 132-3], as compared with only about \$10,000 in 1937 [R. 151], production then declined to about \$700 or \$800 a month [R. 133], and even if petitioner had been able to put the well back on production at a cost of as little as \$500, it would have sustained a loss in operating the well because of the limitation on Smith's share of expenses [R. 139-140]. Furthermore, in quitclaiming the well to Smith, petitioner shifted to him the ultimate liability for conditioning the well for abandonment in compliance with state law. This might have cost between \$5,000 and \$10,000 [R. 134]. By quitclaiming to Smith, petitioner surrendered its interest in the well without incurring this liability.

Although Smith was a large stockholder of petitioner, the transaction was free from any suspicion of intent to benefit him at the expense of the corporation. The matter of surrendering possession of the well to him was not suggested by Smith but by Morton [R. 125]. Smith refrained from any participation in the discussions as to the advisability of the transfer [R. 127], and the resolution records him as not voting [R. 100]. Neither Morton nor any other of petitioner's shareholders had any interest in Smith's operation of the well [R. 127].

In his notice of deficiency the Commissioner disallowed the loss on abandonment of petitioner's interest in well No. 16 "as not falling within the provisions of Section 23 of the Revenue Act of 1936" [R. 50], and at the hearing counsel for the Commissioner placed his objection on the grounds that the quitclaim was to a stockholder, that no effort was made to salvage any property, and that if there was a deductible loss it was one to which capital limitations applied [R. 110]. These objections are obviously without merit. In the case of *United Oil Co.*, 25 B. T. A. 101, 109, the Board of Tax Appeals said:

"Losses sustained on account of the abandonment of oil wells constitute allowable deductions from income for the year or years in which abandoned, and this principle has been specifically recognized by the respondent. Belridge Oil Co., 11 B. T. A. 127, 137."

The evidence shows that Mr. Smith's position as a shareholder did not influence the decision of the board of directors as to the advisability of surrendering the well to him. No effort was made to salvage the well equipment because Smith already owned a half interest in this equipment [R. 124] and because the lessors had the right to possession upon abandonment [R. 125]. And the surrender

to Smith was without consideration and hence not a "sale or exchange" to which the capital loss limitations of Section 117 could apply.

The Board of Tax Appeals' disallowance of the loss is based entirely upon an alleged failure to prove the amount thereof. The Board states that this was the basis of respondent's contest of the deduction [R. 211-12]. This statement rests upon a misconception of the meaning of certain remarks made by counsel at the time of the hearing. One of the principal issues in the case was whether sums expended by the trustees in operating the wells, which sums were charged to petitioner, should be taken into consideration in computing the depletion deduction. Accordingly, it was impossible, before this issue was determined, for petitioner to prove definitely the amount of loss sustained upon abandonment of well No. 16. Counsel for respondent, Mr. Tonjes, was anxious to keep out of the record any documentary evidence which might tend to establish depletion in accordance with petitioner's contentions. Thus, when petitioner attempted to offer in evidence a document entitled "Barnhart-Morrow Consolidated Gross Income, Expense, Depletion, Net Income," Mr. Tonjes objected to the offer for the reason that it attempted to show what was a proper depletion allowance, and the offer was therefore withdrawn [R. 149-50]. When the witness, George F. Meitner, petitioner's auditor, then attempted to identify the document ultimately received as Exhibit No. 57, entitled "Loss on Oil Wells Quit-claimed and/or Abandoned in Year 1937," Mr. Tonjes examined the witness on *voir dire* to satisfy himself that the item of \$28,472.01 shown on the exhibit as "Depletion Reserve December 31, 1935," represented depletion prior to the time the trustees took possession [R. 153-5]. Mr. Tonjes then elicited the information that the items shown

on the exhibit as depletion on the trustee's distribution in 1936 and 1937 were calculated on the amount of gross proceeds of oil credited petitioner by the trustees, that is, in accordance with petitioner's contentions on the depletion issue [R. 155]. Counsel for petitioner recognized that respondent would therefore have a legitimate objection to the exhibit on the ground that it purported to show what was a proper depletion allowance, and in order to avoid this objection, counsel stated that he offered the exhibit

"for the purpose of showing the method and the manner in which petitioner arrived at the figure \$43,-151.96 which the petitioner has claimed to have sustained as a loss on Well No. 16 at the time it was abandoned in 1937, and not for the purpose of showing that it is evidence of the fact that they did sustain that, but to show how we arrived at that figure, to show our method of computing" [R. 155].

When the court then admitted the exhibit in evidence "for the purpose stated by counsel," it was understood by counsel that the exhibit was evidence for all purposes except to show proper depletion allowances on the trustees' distributions or to show the proper *total* amount of the loss sustained by petitioner, which total amount necessarily involved the question of depletion. Certainly the exhibit would have been entirely immaterial had its only effect been to evidence the mental process of petitioner's auditor. The issue was as to the amount of the loss. This clearly appears from the introductory question put to the witness, in which he was asked to state how the figure of \$43,-151.96 claimed as a loss was established [R. 153]. At no time did counsel for respondent question the veracity of the statement as evidence of the original cost of the well.

This is the entire explanation of Mr. Tonjes' earlier statement [R. 119] that while he thought the total sum of \$43,151.96 claimed as a loss "might be correct," he did not concede the amount. The total was not conceded because it embodied a disputed element of depletion, but for no other reason.

Petitioner's Exhibit 57 shows that the cost, less depreciation to December 20, 1937, of the tangible well equipment on well No. 16, was \$14,914.75 [R. 157], that the intangible drilling costs, less depletion, came to \$28,237.12, and that the adjusted basis of petitioner's interest in the well was the total of those sums, or \$43,151.96 [R. 158]. The Tax Court's order of July 30, 1943 [R. 270-2] shows the income from well No. 16 for 1936 and 1937 as follows:

	1936	1937
Gross income	\$46,981.24	\$20,688.87
Net income	26,783.53	16,060.02

Depletion for these years, computed at 27½% of gross income or 50% of net income, whichever is lower, amounted to \$10,344.43 in 1936 and \$7,365.47 in 1937. The sum of these figures, \$17,709.90, is \$251.81 more than the total depletion for the same years shown in Exhibit 57 [R. 158], so the loss on surrender of the well is reduced from \$43,151.96 to \$42,900.15.

Mr. Meitner, petitioner's auditor, testified that the figures shown on Exhibit 57 were taken by him from petitioner's books [R. 153]. These figures, however, were rejected by the Board because "respondent never agreed that petitioner's books reflected actual cost of the well" [R. 212]. We respectfully submit that petitioner's books are *prima facie* evidence of the facts they purport to rep-

resent and that this rule of evidence is not conditioned upon the prior agreement of the Commissioner as to their accuracy. In the instant case there was no evidence or even assertions of counsel to challenge the accuracy of the book entries. Under such circumstances, to deny a corporation the evidence of its books of account would be to leave it at the mercy of the Commissioner as to all matters except those still within the memory of its officers and employees. The mere assertion of such a doctrine is shocking to one's sense of fairness. In *Commissioner v. Brier Hill Collieries* (C. C. A. 6), 50 Fed. (2d) 777, at 778, the court said:

"The Board has frequently held that the balance sheets of predecessor and successor corporations are evidence of asset values. Fidelity Storage & Warehouse Co., 2 B. T. A. 371; Munising Motor Co., 1 B. T. A. 286; Northeastern Oil & Gas Co., 5 B. T. A. 332. Not only did the books of the Crawford Company show these values, but the same items at the same values were transferred to the books of the taxpayer upon the taking over of the properties. Nothing appears in the evidence from which it is to be inferred that the books of either company did not show, as they purported to do, the true value of the assets. In this situation we think the Board should have accepted the book values. *Newton v. Consolidated Gas Co.*, 258 U. S. 165, 42 S. Ct. 264, 66 L. Ed. 538. *Kings County Lighting Co. v. Nixon* (D. C.), 268 F. 143."

In *B. F. Edwards*, 39 B. T. A. 735, at 737, this rule was accepted by the Board when it said:

"The assets of a corporation may be considered in arriving at the value of its stock, *Lillian G. McEwan*,

26 B. T. A. 726, and in the absence of any different showing, the book value of those assets is some evidence of their actual value sufficient to shift the burden of going forward to the respondent. See *Wessel v. United States*, 49 Fed. (2d) 137; *Commissioner v. Brier Hill Collieries*, 50 Fed. (2d) 777."

And very recently, on May 31, 1944, in the case of *Waldo B. Russell*, C. C. H. Dec. 14,007(M), the Tax Court was even more explicit, saying:

"As to the deduction for patent depreciation which respondent has reduced for failure to show an adequate basis, we think the question close but have concluded that petitioners have borne their burden. It is stipulated that 'the books of Russell Box Company show that . . . the patents were transferred to . . . (petitioner) at an amortized value of \$9914.56,' which is the amount used by petitioners as its basis. No contradictory evidence was introduced by respondent who admits 'that such books make such showing,' and merely contends that the books are no evidence whatever. While certainly not conclusive, we have held that entries appearing upon books regularly maintained in the operation of a business furnish some evidence of the facts shown, sufficient to place upon respondent the burden of going forward. B. F. Edwards, 39 B. T. A. 735. We think that rule should be followed here. The entry in question purported to state a fact, namely, the figure at which the property was transferred. It would be necessary to conclude that this fact was misstated in order to disregard the book entry completely. In the absence of some evidence on the subject justify-

ing at least the creation of suspicion, we do not regard so drastic a procedure as required. On this issue petitioners are sustained."

The opinion of the Board member in this case questions whether the \$17,889.48 shown as depreciation on tangible well equipment is the full amount allowable within the meaning of Section 113(b)(1)(B) of the Revenue Act of 1936 [R. 212-3]. This must be assumed, in the absence of any evidence to the contrary or objection by the Commissioner. To require the taxpayer, in every case of loss, to prove that the depreciation taken and allowed was as great as would be "allowable" by the Commissioner, in the absence of any issue raised by the Commissioner himself, would be to require a useless waste of the time of the courts and counsel. The very least that the taxpayer has the right to expect, if the question is raised by the court itself, is an opportunity to supply the deficiency in proof. Here petitioner's motion for a rehearing stated [R. 236]:

"We also petition for a rehearing because, if there be any question that the proof as introduced failed to clarify any of these matters, Petitioner asks for a rehearing to the end that all of such matters can be made clear beyond possibility of doubt. The facts involved are not susceptible of dispute, and the interest of justice, we respectfully submit, requires that all of the facts be before the Board with the utmost clarity."

Yet this motion for rehearing was summarily denied [R. 244].

In this connection we call attention to the case of *Forrester Box Co. v. Commissioner* (C. C. A. 8), 123 Fed. (2d) 225, 228-9, where the court said:

"The Board ruled that the lawful basis, for determining gain was \$128,571.36 less whatever depreciation was allowable during the years 1922 to July 1, 1929. The Board held that the burden of showing the amount of allowable depreciation was upon the petitioner, and that, since it had failed to sustain the burden, the Board had no alternative but to approve the respondent's determination.

\* \* \* \* \*

"It is apparent that the petitioner's evidence was directed toward proving the nonexistence of actual depreciation, and not toward proving the amount of allowable depreciation. The petitioner demonstrated that the respondent's determination was based on an erroneous theory, but it failed to prove, as the Board has pointed out, the amount of depreciation which was allowable from 1922 to 1929 with respect to the machinery and equipment. The Board was of the opinion that a far greater depreciation was allowable than the petitioner had taken. In effect, the Board ruled that, while the respondent's determination, which had been appealed from by the petitioner, was based on an utterly untenable theory, the petitioner must accept that determination because of its failure to show that its own theory as to the basis for determining gain on the sale of the machinery and equipment in 1929 was correct.

"It is obvious now that both the respondent and the petitioner were shooting wide of the mark in the proceedings before the Board. It is also apparent

that if the Board's order is affirmed, the taxpayer will, in all probability, be required to pay taxes in an excessive and arbitrary amount. While it may be true, as the Board remarks, that allowable depreciation on \$128,000 worth of machinery during 7½ years must have exceeded \$1,893.89, it would seem to be equally apparent that the allowable depreciation on such machinery would not have been as great as \$128,000. Under the circumstances, we think that it was the duty of the Board, after it had decided what the proper basis was for determining gain, to afford the petitioner an opportunity to show what the allowable depreciation on the machinery and equipment was from the time it acquired it up to July 1, 1929. See and compare, Helvering v. Taylor, 293 U. S. 507, 515, 516, 55 S. Ct. 287, 79 L. Ed. 623; Clements v. Commissioner, 8 Cir., 88 F. 2d 791, 793; Johnson v. Commissioner, 8 Cir., 88 F. 2d 952, 956; National Lumber & Tie Co. v. Commissioner, 8 Cir., 90 F. 2d 216, 219."

See also, in this connection, the following cases:

*Royal Highlanders v. Commissioner* (C. C. A. 8),  
138 Fed. (2d) 240, 245;

*Eau Claire Book & Stationery Co. v. Commr.*  
(C. C. A. 7), 65 Fed. (2d) 125, 126;

*Underwood v. Commr.* (C. C. A. 4), 56 Fed. (2d)  
67, 72-3.

The opinion further states that the record is devoid of any evidence to show that the intangible drilling costs of Well No. 16 were not "deducted as ordinary and necessary business expenses in the year in which they were incurred, as permitted by article 243, Regulations 74"

[R. 213]. One complete answer to this suggestion is that a corporation which agrees to drill a well in consideration of an interest in the well site is not permitted to deduct the drilling costs as an expense. In *Hardesty v. Commissioner* (C. C. A. 5), 127 Fed. (2d) 844-5, the court said:

“Taxpayers seek a deduction from gross income, predicating their case solely upon the provisions of Article 23(m)-16 of Treasury Regulations 94. The drilling and development costs dealt with by this article are those incurred by a taxpayer in connection with the development of his own property or lease. \* \* \* The regulation was not intended to and does not apply to costs incurred in the drilling of oil wells on the lands of others, or to costs incurred in connection with the drilling of wells as the purchase price of or as consideration for an interest in the lands of others.”

The decision of this Honorable Court in *United States v. Sentinel Oil Co.*, 109 Fed. (2d) 854, cert. den., 310 U. S. 645, 84 L. Ed. 1412, is to the same effect. Petitioner's agreement of September 28, 1928 to drill Well No. 16 at its own expense was made concurrently with the transfer to petitioner of the lease of the well site [R. 187] and was obviously the consideration for that transfer. That this was a capital transaction was in effect conceded by the allowance to petitioner of depletion on the production of Well No. 16. See *Commissioner v. Rowan Drilling Co.* (C. C. A. 5), 130 Fed. (2d) 62, 63-4, where the court said:

“The Rowan Drilling Company having given its drilling services in consideration of oil payments, the costs incurred by it as a consequence of the drill-

ing constituted the purchase price paid by it to acquire a capital asset. This much seems to be conceded by the taxpayer, for it claimed depletion deductions with respect to its income from such oil payments."

Furthermore, Exhibit 51 shows intangible costs of Well No. 16 under the heading of "Capital Assets" [R. 103]. The suggestion that, while capitalizing these items on its books, petitioner might be "expensing" them for income tax purposes, was conjured up by the Board and is not based on any evidence or taken from any statement made to it by counsel for respondent. This suggestion is refuted by the fact that the intangible drilling cost of Well No. 16 increased from \$60,908.31 as of December 31, 1935 [R. 103] to \$74,167.31 as of December 20, 1937 [R. 158], an increase of \$13,259 during the very tax years here in question. The Board member must have known, and it *affirmatively appears* from Exhibits 60 and 61 [R. 181-182], that no deduction was taken for any sum expended for drilling in those years. Certainly, under these circumstances, it was improper for the Board to disregard the flat assertion in the affidavit of Mr. Meitner, submitted in support of petitioner's motion for rehearing, that "petitioner has never expensed intangible drilling costs" [R. 242].

Finally, the Board states that "no allowance was made by petitioner in the computation for the salvage value of the well" [R. 213]. The testimony of Harold C. Morton clearly shows that the well equipment was surrendered with the well, and the directors considered it a good bargain [R. 124-5]. There was nothing left from which petitioner might salvage any part of its loss.

If there *was* any deficiency in proof of the amount of petitioner's loss on Well No. 16, it can very easily be remedied, and common justice would require that petitioner be given the opportunity to submit any additional evidence required. As things stand, it appears that petitioner actually sustained a large loss which the Revenue Laws permit it to deduct in determining its income tax liability, but that it is being denied the deduction and taxed excessively on purely technical grounds. We firmly believe that if the cause is remanded to the Tax Court, counsel for respondent, knowing that all necessary additional evidence is available and cannot be controverted, will stipulate to the deduction in the full amount of \$42,900.15 claimed.

### Conclusion.

For the reasons above set forth, it is respectfully submitted that the decision and order appealed from should be reversed and remanded for further appropriate proceedings.

HAROLD C. MORTON,  
LEON B. BROWN,

*Attorneys for Petitioner.*

No. 10806

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In the United States Circuit Court of Appeals  
for the Ninth Circuit

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BARNHART-MORROW CONSOLIDATED, A CORPORATION,  
PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

---

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX  
COURT OF THE UNITED STATES

---

BRIEF FOR THE RESPONDENT

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PAUL P. O'BRIEN,  
CLERK



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# In the United States Circuit Court of Appeals for the Ninth Circuit

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No. 10806

BARNHART-MORROW CONSOLIDATED, A CORPORATION,  
PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

---

*ON PETITION FOR REVIEW OF THE DECISION OF THE TAX  
COURT OF THE UNITED STATES*

---

## BRIEF FOR THE RESPONDENT

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## OPINIONS BELOW

The opinion of the Tax Court of the United States (then the Board of Tax Appeals) (R. 184-213), is reported in 47 B. T. A. 590. The order of February 29, 1944, denying the motion for rehearing (R. 296-300), is unreported.

## JURISDICTION

This case involves the income tax liability of Barnhart-Morrow Consolidated, a California corporation, for the calendar years 1936 and 1937. Notice of deficiencies was mailed on September 18, 1940 (R. 41), and the petition for redetermination was filed with the Tax Court on December 13, 1940 (R. 1), pursuant to Section 272 (a) of the Internal Revenue

Code. The denial of the motion for rehearing was entered on February 29, 1944. (R. 300.) The petition for review was filed on May 15, 1944. (R. 300-305.) The jurisdiction of this Court rests on Sections 1141 and 1142 of the Internal Revenue Code.

#### **QUESTIONS PRESENTED**

Whether under the evidence the Tax Court was not correct in determining that taxpayer:

I. Was not insolvent and in receivership in 1936, within the meaning of Section 14 (d) (2) of the Revenue Act of 1936?

II. Was not entitled to a rehearing on the question of the applicability of the deficit credit provision of Section 26 (c) (3) of the Revenue Act of 1936, to its 1936 undistributed net income?

III. Had expressly waived raising and was not entitled to a rehearing to question the disallowance of additional receivership expenses for 1936?

IV. Had not sustained the burden of proving the amount of any loss sustained in the relinquishment or exchange of its one-half interest in Well No. 16 in 1937?

#### **STATUTES INVOLVED**

The applicable provisions of the statutes involved are set out in the Appendix, *infra*.

#### **STATEMENT**

Taxpayer is a California corporation organized in 1926 to operate and manage oil and gas wells. (R. 186.) It kept its books and filed its returns on the accrual basis. (R. 186.) In 1927 it acquired

by assignment the right to operate five oil and gas wells in the Santa Fe Springs field, known as Julian Wells Nos. 1, 2, 3, 11, and 12. (R. 68, 186, 187.) On March 9, 1928, W. J. Barnhart, acting for C. C. Julian (R. 188), acquired the United lease (R. 187), and on September 28, 1928, taxpayer agreed with Barnhart to drill at its own expense a well on the property to productive sands below 5,000 feet (R. 187). After payment of landowner's royalty of 16 $\frac{2}{3}\%$  if a well was drilled less than 5,000 feet, and 20% if drilled more than 5,000 feet, taxpayer was entitled to receive \$100,000 out of the remaining production. Thereafter the 83 $\frac{1}{3}\%$  interest of the lessee was to be divided equally between taxpayer and Barnhart after paying operating expenses, except that Barnhart's interest was not chargeable with more than \$250 per month while the well was flowing, and \$500 per month while the well was being pumped. (R. 187-188.) Taxpayer also agreed to pay C. C. Julian the sum of \$2,500 to be relieved of its obligation to drill a well deeper than 5,000 feet, and to accept \$80,000 instead of \$100,000 for the drilling of such well. (R. 188.) Thereafter, taxpayer drilled a productive well on property known as Julian Well No. 16 to a depth of less than 5,000 feet. (R. 188.)

Julian, acting through Barnhart, thereafter assigned his interest in Well No. 16 meditately to J. A. Smith. (R. 188-189.) Taxpayer and Smith then were the owners of Well No. 16.

In 1930 taxpayer undertook to operate Well No. 17, which had been drilled by Julian on another part of the United lease. (R. 189.)

All the above mentioned wells were allegedly purchased by R. L. Mack in an execution sale held to satisfy a judgment obtained by one Garliepp against Julian in 1929. (R. 190.) Mack conveyed his interest to W. A. Schwartz,<sup>1</sup> who thereupon claimed to be the owner of the wells, except for the royalty interests. On January 19, 1931, Julian instituted suit in the California state court to restrain Schwartz from taking possession of the wells. (R. 190.) On March 19, 1931, the court appointed two individuals as receivers to operate the wells under existing leases, sell the production of the property, paying therefrom royalties and expenses incident to the receivership and the operation of the wells, and retain other funds until further order of the court. (R. 190.) On March 23, 1932, pursuant to a stipulation of all the parties to the action, the court appointed two trustees to operate the wells, but continued the receivership for the purpose of carrying on the litigation. (R. 190.) Judgment was entered in the case on September 7, 1933. The court held that taxpayer and J. A. Smith were each entitled to one-half interest in Well No. 16, subject to the terms of the lease entered into on March 9, 1928. (R. 190-191.) The judgment was affirmed by the District Court of Appeals on August 28, 1936. *Julian v. Schwartz*, 16 Cal. App. 2d 310. The case was finally determined on October 28, 1936, upon the denial of a hearing by the Supreme Court of California. (R. 191.)

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<sup>1</sup> Schwartz is the nominee or straw man for J. A. Smith (*Julian v. Schwartz*, 16 Cal. App. 2d 310, 316).

On or about July 29, 1931, D. R. Morrow brought an action in the state court of California against taxpayer, Hardison, and Barnhart, for an accounting of the affairs of taxpayer; for an accounting to taxpayer by Barnhart, general manager, and Hardison, president of taxpayer, for any and all profits including secret profits, and for unlawful payments set forth in the complaint; contesting unlawful and excessive salaries paid to Barnhart and Hardison; and for the appointment of a receiver to take charge of the affairs and assets of taxpayer *pendente lite*. It was alleged in the complaint that Barnhart and Hardison had caused to be paid to themselves and credited to them excessive salaries from 1928 in the amount of \$1,000 each per month. On the same day the court appointed Ralph S. Armour as receiver for taxpayer. (R. 191-192.)

The questions relating to a salary of \$14,000, which had been accrued on taxpayer's books in favor of Hardison, and notes in the amount of \$8,500 payable by taxpayer to Hardison, were not settled until December 11, 1936, when the board of directors of taxpayer authorized the payment of \$7,000 to him for salary to December 30, 1930. At that time Hardison admitted that the salary accrued in his favor was excessive. (R. 192-193.) The remainder of the salary, being for the first seven months of 1931 during which taxpayer's affairs were in the hands of the receiver appointed in connection with the *Julian v. Schwartz* litigation, was not recognized and paid. Such salary

was written off in 1936 as of 1931 and credited to surplus.<sup>2</sup> (R. 146, 193.)

The net income or the net loss of taxpayer each year from 1930 to 1935 was as follows (R. 193):

	Net Income	Net Loss
1930	\$3, 175. 54	-----
1931	-----	\$90, 116. 67
1932	-----	5, 213. 85
1933	666. 27	-----
1934	-----	2, 516. 00
1935	-----	6, 063. 64

In accordance with the instructions of the court, the trustees kept a record of the income and operating expenses of each well. On July 23, 1934, the court issued an order directing the trustees to pay from the funds in their possession certain amounts including \$102,885.93 to taxpayer. (R. 193.) The court order was ineffective during the pendency of the appeal in the *Julian v. Schwartz* litigation. It became effective on October 28, 1936, when the case was finally determined and adjudicated. The amount of cash distributed to taxpayer in 1936, pursuant to the order, was \$112,000. In 1937 taxpayer received an additional sum of \$121,037.94 from the proceeds, pursuant to a court order entered in February, 1937. The trustees paid the sum of \$17,852.13 to the receiver in 1936 for the account of taxpayer. (R. 193-194.)

While the proceeding was pending, Ralph S. Armour, the receiver of taxpayer, was never in complete charge or control of the assets of taxpayer,

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<sup>2</sup> The notes payable in the sum of \$8,500 were also canceled.

since the oil wells at Santa Fe Springs were in control of and being operated by the trustees. (R. 194.) Thus, the assets shown in the balance sheet (Ex. 51; R. 103, 194-195) as capital assets, except a well known as the Hartley Well (not carried as an asset after 1930), and office furniture and fixtures shown in the books after 1931 as a value of \$811.50, were not in the possession of taxpayer from the time of the appointment of the receiver in 1931 until the final determination of the *Julian v. Schwartz* litigation in 1936, and were being claimed by Schwartz and others, as asserted in the proceeding. (R. 195.) The financial condition of taxpayer remained about the same from January 1, 1936, until the receipt in 1936 of funds from the trustees. (R. 195-196.)

The income and expenses of taxpayer for 1936 were as follows (R. 196):

#### INCOME

Oil and gas sales after November 1, less expenses-----	\$6,436.30
Rental on drilling equipment-----	5,000.00
Distribution from trustees-----	142,989.99
Claim for interest relinquished-----	391.67
	_____
	154,817.96

#### EXPENSES

Interest paid-----	\$1,409.36
Loss, erroneous payments to J. A. Smith-----	16,500.10
Receivership -----	17,574.68
	_____
	\$35,484.14
Net income-----	119,333.82

None of the income impounded by the trustees in the *Julian v. Schwartz* litigation was considered as income to taxpayer until released to it. In and after 1933, pursuant to a stipulation filed with the court in 1933, there were released to J. A. Smith for the account of

taxpayer proceeds of gas production of Wells Nos. 1, 2, 3, and 11 accruing to taxpayer. (R. 196.) At a hearing held in Washington, D. C., on August 13, 1937, these amounts were determined to have been constructively received by taxpayer in 1933 and years subsequent thereto. There was deducted from such income depreciation on the tangible equipment of the wells and other tangible lease equipment which was then being used by the trustees. In addition to the depreciation so deducted, there were deducted and allowed business expenses paid and accrued, including legal fees and receivership expenses. The receivership expenses so allowed were allowed as deductions in and for the years ~~for~~<sup>in</sup> which they were definitely determined and approved by the court. (R. 85, 196-197.)

On November 12, 1936, Ralph S. Armour, receiver, filed with the court a final account and report showing that during the period of the receivership he had incurred expenses, aggregating \$17,852.12, for the years 1931 to and including 1936 with the exception of 1935. (R. 197.)

The court approved the account the day it was filed. In its order approving the account, the court said (R. 198) :

\* \* \* it appearing to the court that defendant, Barnhart-Morrow Consolidated, a corporation, is no longer insolvent by reason of its success in the litigation entitled: *Julian v. Schwartz*, No. 315-345, in this court, now finally determined on appeal, and that by reason of the termination of said litigation and the present solvency of said corporation, there is no

longer any reason for the continuance of said receivership herein \* \* \*

and directed that the receiver's expenses be paid out of the first moneys accruing and paid to taxpayer.

The taxpayer's share of the gross proceeds of production of Julian Wells Nos. 1, 2, 3, 11, 16, and 17 for the period of December 1, 1930, to November 14, 1936, during which time the wells were in possession of and being operated by the trustees, was \$488,903.65. The total charges made against taxpayer by the trustees for the operation of the wells during that period were \$223,352.83, leaving a balance of \$265,550.82 payable to taxpayer. Of the net amount of impounded funds due taxpayer, \$142,989.99 was paid to it in 1936, \$122,371.37 in 1937, and the balance of \$189.46 in subsequent years. The payment made in 1936 consisted of the following items: cash paid to Ralph S. Armour, receiver, for receivership expenses, \$17,852.13; cash to taxpayer, \$112,000; depreciated cost of well equipment acquired by trustees and delivered to taxpayer on November 14, 1936, \$7,992.90; compensation insurance, \$300; liabilities of taxpayer paid by trustees, \$4,844.96. (R. 198-199.)

The taxpayer sustained an operating loss of \$3,258.78 in the operation of Well No. 16 in 1937 up to the time it ceased producing because of unknown damage to the well. Work of an undescribed nature on the well was necessary to ascertain the kind and extent of the damage and the cost of making repairs. J. A. Smith, the owner of the other one-half interest in the well, including its equipment, was not liable for more than

\$250 per month for operating expenses of the well. (R. 117, 124, 199.)

The terms of the United lease required taxpayer to operate Well No. 16 even though in doing so it sustained a loss (R. 124, 199), and in the event that taxpayer abandoned the well the lessor had the right to take possession thereof, including its equipment, and hold or operate the property at its own expense, free from any claim of the taxpayer, subject, however, to a royalty of 8½% to taxpayer. In case the lessor did not exercise the right to take over any abandoned well, taxpayer was obligated to restore the premises to their original condition, including the plugging of the well in accordance with the laws of California. (R. 134, 199.) The cost of plugging a well is from \$5,000 to \$10,000. (R. 134, 199.) The well had some salvage value, probably \$2,000. (R. 125, 199.)

In December 1937, Harold G. Morton, an experienced oil operator and counsel, and a director and stockholder of taxpayer, suggested to the board of directors of taxpayer that the well be abandoned. At that time J. A. Smith held about 35% of taxpayer's stock and Harold G. Morton and another individual each held about 9%. (R. 126, 199-200.) The remainder of the stock was widely distributed. On December 20, 1937, the board of directors of taxpayer adopted a resolution to surrender the well, and the premises pertaining thereto, to J. A. Smith and executed a quitclaim deed for the property in his favor. (R. 100, 200.)

Work done on the well immediately thereafter by J. A. Smith revealed that the liner thereof had

crumpled. The damage was repaired at a cost of about \$800. The well sustained similar damage in 1936 and was repaired at a cost of about \$18,000. (R. 130-131, 200.)

The well was placed on production in January 1938, in which month it produced oil and gas of a value of about \$1,500. The gross production of the well was increased to \$2,550 in April, 1938, and thereafter it decreased to \$700 or \$800 in October 1941. (R. 132-133, 200.)

The Tax Court, in its opinion of August 20, 1942, held, *inter alia*, that taxpayer had not sustained the burden of proving that it was insolvent and in receivership in 1936, within the meaning of Section 14 (d) (2) of the Revenue Act of 1936 (R. 207) or the amount of any loss it sustained in connection with the transfer of its interests in Well No. 16 in 1937 (R. 213). On September 17, 1942, taxpayer filed a motion for rehearing and reconsideration of the insolvency and Well No. 16 issues (R. 214-243, 296), which was denied by the Tax Court on December 4, 1942 (R. 244-246, 296-297). After the approval of the Revenue Act of 1942, on October 21, 1942, no motion was filed to apply Section 501 of that Act, which added Section 26 (c) (3) to the Revenue Act of 1936, by the presentation of additional evidence or otherwise, nor was any application made to amend the pleadings to cover the issue. (R. 297.) The question of whether, under such section, taxpayer was a deficit corporation on December 31, 1935, was first suggested, and taxpayer's contention was first set forth in a Rule 50 recomputation filed by taxpayer on March 26,

1943, by reference to the balance sheet of December 31, 1935 (R. 103-104), showing an alleged deficit of \$172,161.65 (R. 246, 297). The necessity for further evidence on the issue was not alleged and the insolvency and Well No. 16 questions were not again raised.<sup>3</sup> (R. 246, 297.)

On May 5, 1943, at the hearing on the recomputations, taxpayer submitted the deficit credit matter upon the facts already in the record, and elected not to file a memorandum on this subject, stating that the facts were already in the record. (R. 263-267, 297-298.) After consideration of the evidence on record, which consisted of the balance sheet at the close of 1935 (R. 103-104), the Tax Court modified and supplemented its order of December 4, 1942, on other issues only (R. 270, 298). Revised recomputations were ordered filed (R. 298) and the application of Section 501 was again presented in recomputation, with no suggestion of additional evidence being necessary R. 273, 298).<sup>4</sup> The matter came on for hearing on January 5, 1944, after continuance at taxpayer's request (R. 298), and was decided adversely to taxpayer on January 24, 1944 (R. 285). On February 17, 1944, taxpayer filed another motion for rehearing on the grounds the Tax Court did not consider the applicability of Section 26 (c) (3), that additional evidence would be submitted, consisting of an analysis of the deficit account, and that the Tax Court erred in holding the taxpayer was not

<sup>3</sup> Among the deductions claimed were the disallowed receivership expenses. (R. 250.)

<sup>4</sup> See footnote 3.

insolvent in 1936, was not entitled to deduct the additional receivership expenses, and did not prove the amount of its loss in relinquishing its interest in Well No. 16. (R. 4, 286-291, 296.)

In denying the motion, the Tax Court held that the insolvency and Well No. 16 issues had previously been thoroughly considered, that the matter of receivership expenses was waived at the original hearing, and was not discussed in taxpayer's briefs nor at the hearing under Rule 50, and that no newly discovered evidence relating to the deficit credit question was suggested. (R. 296-300.) From the decision of the Tax Court sustaining the determination of deficiencies in taxpayer's income tax for 1936 and 1937, taxpayer prosecutes this appeal.

#### SUMMARY OF ARGUMENT

1. Taxpayer was not insolvent in 1936, within the meaning of Section 14 (d) (2). Its assets greatly exceeded its total liabilities, and it did not demonstrate that it was unable to meet its liabilities as they matured. The only substantial business activity carried on was the operation of the wells by the trustees in the *Julian v. Schwartz* litigation, and they admittedly from the proceeds from the sale of oil, paid the cost and expenses of the operation of the wells. No other liabilities were shown to have matured or have been due and payable in 1936. Insolvency denotes a "general" inability to meet liabilities as they mature by means of either available assets or use of credit, and "meet" is not to be construed as "pay". The balance sheet can justifiably be interpreted to show that if

some liabilities existed, they were met by the employment of credit which obtained renewals and extensions of time.

2. Taxpayer had full opportunity to present its case before the Tax Court. It voluntarily and expressly chose to have the question of the deficit credit provision of Section 26 (c) (3) of the Revenue Act of 1936 decided on the state of the record as it now exists. The only evidence of record is a balance sheet as of December 31, 1935, showing an alleged deficit of \$172,161.65, but which does not purport to show the deficit to be in accumulated earnings and profits. The record evidence is insufficient to allow the credit, and although the motion for rehearing is directed toward an analysis of the deficit account, nothing newly discovered, since the taxpayer elected not to present additional evidence, is suggested. Under California law it was in no way prohibited from paying dividends in 1936. It was a wasting asset corporation and had net profits during 1936, from which cash dividends could have been paid, even though its assets might have been somewhat impaired.

3. The matter of the disallowance of additional receivership expenses for 1936, although put in issue by the pleadings, was expressly waived by taxpayer at the proceeding before the Tax Court, and was not discussed in the briefs nor at the hearing under Rule 50. Taxpayer, therefore, is precluded from raising the question on this appeal. The claim, moreover, has no merit, since taxpayer had stipulated with representatives of the Bureau of Internal Revenue that the receivership expenses were to be allowed as deductions

in and for the years in which they were definitely determined and approved by the state court having jurisdiction over the receiver. This does not mean, as taxpayer asserts, for and in the year the court did the approving. Although the state court approved the receiver's account in 1936, it did so for the incurrence of expenses for the years 1931 to and including 1936, with the exception of 1935. Taxpayer presumably has already taken the benefit of these deductions in computing its taxable income for these prior years, and cannot now obtain a double benefit by the allowance of the deductions again for the year 1936.

4. Taxpayer failed to prove the amount of any loss sustained on the relinquishment or sale of its one-half interest in Well No. 16 to Smith. It introduced no evidence for the purpose of showing the adjusted cost or other basis of the well. The only evidence in the record is an exhibit which was offered—

not for the purpose of showing that it is evidence of the fact that they did sustain [a loss of \$43,151.96] but to show how we arrived at that figure, to show our method of computing.

Since the amount of the loss was contested from the outset of the hearing before the Tax Court, there was no abuse of discretion by that court in its refusal to open the case and retry the issue. Moreover, by the transfer, taxpayer was relieved from the terms of a very undesirable operating contract and released from any personal liability for conditioning the well for purposes of abandonment under California law. Taxpayer thus received a *quid pro quo* from the transfer, and Smith took the whole interest in the well, burdened

with the liability of conditioning it in the event of abandonment. This constituted a sale or exchange of a capital asset within the meaning of the \$2,000 limitation provision of Section 117 (d).

#### **ARGUMENT**

##### **I**

###### **Taxpayer was not insolvent and in receivership in 1936, within the meaning of section 14 (d) (2) of the Revenue Act of 1936**

The sole question on this phase of the case is, as stated by taxpayer (Br. 6), whether it was insolvent in the equity or commercial sense. The Government does not, in the light of the decision of this Court in *Artesian Water Co. v. Commissioner*, 125 F. 2d 17, argue that a receivership contemplated by Section 14 (d) (2) (Appendix, *infra*) was intended to mean one caused by financial difficulties and not one arising, as here, from disputes between shareholders and directors over secret profits, excess salaries, and mismanagement. (R. 191-192.) However, it is desired to preserve that question. Nor does taxpayer even assert that it was insolvent in the bankruptcy sense of having liabilities in excess of assets. The mere fact that an appeal was pending from the determination in its favor of litigation over title to the bulk of its assets obviously does not justify the exclusion of these assets from the balance sheet any more than do the countless law suits to which a common carrier is constantly being subjected and which represent contingent liabilities restricting in some sense absolute disposal of property. See Glenn, *Liquidation*, Sec.

19. Time is not of the essence, for this purpose, and the successful termination of the litigation corroborates taxpayer's prior solvency.

To prevail, taxpayer must therefore demonstrate that it was unable to meet its obligations as they matured by available assets or a reasonable use of credit. *United States v. Anderson Co.*, 119 F. 2d 343 (C. C. A. 7th); *Artesian Water Co. v. Commissioner*, *supra*. And since this is a question of fact (Fletcher, Corporations, Sec. 7365), it must show further that in so far as this is an accounting problem the Tax Court's holding was clearly erroneous. *Dobson v. Commissioner*, 320 U. S. 489, rehearing denied, 321 U. S. 231.

That all of taxpayer's oil and gas properties were in the possession and control of the trustees appointed by the court in the *Julian v. Schwartz* litigation does not materially affect the question of taxpayer's solvency. For when the California court originally appointed the trustees (then called receivers), they were authorized to operate the wells, collect the proceeds, pay royalties and all necessary operating expenses in connection with the wells and receivership. And during the year 1936, they were empowered to pay from the proceeds from the sale of oil, the cost and expenses of the operation of the wells. In so far as there was any substantial business activity, it was carried on by the trustees. No suggestion can seriously be advanced that they were unable to meet their obligations as they matured. During the time the wells were in possession of and being operated by the trustees, taxpayer's share of the gross proceeds of

production was \$488,903.65, with total charges for the operation of the wells being \$223,352.83, leaving a balance of \$265,550.82, almost all of which was paid to taxpayer in 1936 and 1937. (R. 198.) In the commercial or equity sense, insolvency has to do with the inability to run a going business, to make ends meet. There was no such inability here. The situation cannot be distinguished from taxpayer's setting up for accounting purposes a separate department to operate and manage the wells. Had this been done, no one could successfully assert taxpayer was therefore rendered insolvent.

But taxpayer bottoms its contention upon corporate liabilities, which it claims could not be paid out of proceeds from the production of the wells until the litigation terminated in its favor. Mention is also made that in four of the six years from 1930 to 1935, it suffered a net loss. (R. 193.) However, a net operating loss is no proof of insolvency (*Shonnard v. Elevator Supplies Co.*, 111 N. J. Eq. 94; *Argalas v. Frank Theiss Co.*, 115 N. J. Eq. 561); and an examination of the comparative balance sheets (*United States v. Anderson Co.*, *supra*), reflects the weakness of taxpayer's position.

Cases construing the present New Jersey Business Corporations Act (New Jersey Statutes Annotated, Sec. 14-3), which deals with the appointment of a receiver for an insolvent corporation, are cited by most of the authorities as controlling examples of insolvency in the equity sense. Glenn, Liquidation, Sec. 13; Gerdes, Corporate Reorganizations, Sec. 96; Fletcher, Corporations, Sec. 7360. Insolvency in this sense de-

notes a "general" inability to meet liabilities as they mature by means of either available assets or an honest use of credit. *Hersh v. Levinson Bros., Inc.*, 117 N. J. Eq. 131; *Artesian Water Co. v. Commissioner*, *supra*. And the word "meet" is not to be construed as "pay". *Hoagland v. United States Trust Co.*, 110 N. J. Eq. 489, 502. A temporary financial embarrassment may be alleviated by the employment of credit to obtain renewals of bills payable and an extension of time for the payment of other obligations. If this is done, no insolvency exists. *United States v. Anderson Co.*, *supra*; *Hersh v. Levinson Bros., Inc.*, *supra*.

An examination of the balance sheet at the close of 1935 (R. 103-104) reveals that even eliminating the disputed capital stock issued for services and leases, there existed some \$44,000 worth of liabilities to some \$350,000 worth of assets. Apparently there was no substantial change prior to the termination of the trusteeship in 1936. (R. 205.) The Tax Court pointed out that except for the salary to Hardison, which was claimed to be excessive in the shareholders' suit, there was no showing whatever that these liabilities matured during the receivership or were due and payable during the taxable year 1936. (R. 206.) Taxpayer claims that because they were listed on the balance sheet under such headings as notes and accounts payable, this shows they were not contingent and unmatured. The litigation over the \$14,000 salary item (R. 206), demonstrates that this amount was contingent and not to be considered as a liability for purposes of insolvency (Glenn, Liquidation, Sec. 19), and it cannot seriously

be suggested that notes and accounts payable always represent obligations already due. They may just as well signify obligations to become due within a certain period of time. Kester, Principles of Accounting 29.

Since taxpayer would not be insolvent if it were able in 1936 to meet, as distinguished from pay, its liabilities, it is interesting to note their nature. Fourteen thousand dollars was owed to Hardison, who was the president of taxpayer. (R. 192.) Not only was this a contingent liability because of the dispute but Hardison had previously agreed that he would accept \$7,000 in full payment of all salary claims, and further, would acquiesce in the cancellation of notes of the corporation which he held in the sum of \$8,500. (R. 193.) Thus, this creditor, who was the president of taxpayer, in no way was pressing it for payment and was amicably seeking an adjustment of the claim. Taxpayer was able to meet this pecuniary liability, assuming it existed, by securing an extension and renewal, as evidenced by the prior agreement. The fact is was able to do so shows that it had credit at its disposal (*Hoagland v. United States Trust Co., supra*), and that \$8,500 worth of notes, together with the salary claimed, did not have to be immediately taken care of during the ten months of 1936. So also for the amount of \$6,995.63 due shareholders. (R. 104.) That this sum remained constant since 1931 may well demonstrate that the shareholders were not seeking immediate payment of their claims, even if they were then due. As part owners of the enterprise, realizing their best interests depended upon the successful outcome of the litigation, the Tax

Court could surely draw the inference that they were content to sit back and wait for payment until the termination of the controversy. The amount of \$4,518.22 was an account receivable from J. A. Smith, a principal shareholder, contra the indebtedness due him. (R. 103.) Taxpayer may say this therefore was not an asset (Br. 12), but surely it reduced on the liability side the amount due to stockholders, which must have included Smith. The \$21,978.09 due from Barnhart, although it remained constant for several years, was listed as an amount receivable beyond one year. There is no showing it was already due and unpaid and therefore not worth anything. From the bare appraisal of the balance sheet, the Tax Court could reasonably impute as much substance to it as to the few liabilities portrayed.

That the Tax Court may have made a "glaring error" (Pet. Br. 10), in construing capital stock issued for services and leases (R. 103) as an asset which could be used as security for a loan or sold to pay debts, is unimportant. Taxpayer's credit was available and used, if the liabilities had any substance, to secure extensions until the appeal was decided in its favor. Obviously, taxpayer can get no help from the statement in the state court's order of November 12, 1936, dissolving the receivership, that taxpayer was no longer insolvent by reason of its success in the *Julian v. Schwartz* litigation. (R. 198.) As the Tax Court said (R. 206-207):

It does not appear that the court ever had before it the question of solvency or insolvency of \* \* \* [taxpayer]. Neither does it ap-

pear that any of the parties in interest ever alleged such a fact in pleadings before the court. On the contrary, the complaint filed by D. R. Morrow, which resulted in the appointment of the receiver, alleged, among other things, that the corporation had been in a prosperous condition and was then operating at a profit, but that the profits were being diverted from the stockholders and \* \* \* [taxpayer].

Whether the Tax Court did or did not use language contrary to the decision of this Court in the *Artesian Water Co.* case, as taxpayer asserts (Br. 12), is totally irrelevant.<sup>5</sup> We do not have here a situation where by reason of the impounding of the assets in the trusteeship, taxpayer was unable to meet maturing obligations. The operating expenses were paid for by the trustees managing the wells, and other liabilities were not demonstrated to the satisfaction of the Tax Court, to have either actually matured or, if they had, to have not been met by the use of taxpayer's credit.

The burden was on taxpayer to establish its insolvency and the deficiency of proof must operate against it. Although insolvency was in issue from the beginning, taxpayer did not seek to introduce in evidence its balance sheets for the years 1936 and 1937,

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<sup>5</sup> Since Section 14 (d) (2) requires a corporation to be both insolvent and in receivership, we submit that the *Artesian Water Co.* case cannot be interpreted categorically to mean that the corporation as distinguished from the receiver must be able to satisfy creditors. The corporation is solvent if the receiver in charge of the assets is able to meet the obligations as they mature. Otherwise, receivership alone would bring the corporation within the benefit of Section 14 (d) (2).

which would have been some evidence of whether these liabilities which it claims were real and matured, were actually paid after it received the impounded funds. In a period of more than one year after the Tax Court denied taxpayer's first motion for rehearing on this question (R. 197), it filed two recomputation statements, which apparently accepted the decision. Then, in the final motion for rehearing (R. 286), the matter was again raised and denied. There was no abuse of discretion by the Tax Court in its refusal to open the case and retry the issue. *Jankowsky v. Commissioner*, 56 F. 2d 1006 (C. C. A. 10th).

## II

**Taxpayer is not entitled to a rehearing on the question of the applicability of the deficit credit provisions of section 26 (c) (3) of the Revenue Act of 1936 to its 1936 undistributed net income**

Taxpayer predicates its appeal from the refusal of the Tax Court to allow any credit under Section 26 (c) (3) of the Revenue Act of 1936, as amended by Section 501 (a) of the Revenue Act of 1942 (Appendix, *infra*) for its alleged deficit in accumulated earnings and profits at the close of 1935, upon the ground that every fact necessary to show its right to a deficit credit can be established by competent evidence. (Br. 29.) But taxpayer had full opportunity to adequately present its case before the Tax Court, and voluntarily and expressly chose to have the issue of the deficit credit decided on the record as it then stood and now exists. If the interests of justice require any thing, they require an end to this long drawn out litigation.

The original opinion was promulgated on August 20, 1942. (R. 184-213.) Since this was prior to the approval on October 21, 1942, of the Revenue Act of 1942, c. 619, 56 Stat. 798, Section 501 (a) of which added Section 26 (c) (3) to the Revenue Act of 1936, the question of the deficit credit was neither raised by the parties nor discussed by the court. The first motion for rehearing filed on September 17, 1942, obviously also dealt with other matters. (R. 214.) It, however, was first suggested on March 26, 1943, in taxpayer's computation under Rule 50, pursuant to the order of the Tax Court of December 4, 1942. Reference was made only to the balance sheet of December 31, 1935 (R. 103-104), showing an alleged deficit of \$172,161.65 but which does not purport to show the deficit to be in accumulated earnings and profits. The necessity for further evidence on the issue was not alleged. (R. 297.) On May 5, 1943, at the hearing on the recomputations submitted, the question of the deficit credit was discussed and taxpayer expressly elected to have the question decided on the state of the then existing record. In response to a question from the Tax Court whether he wished to offer new evidence on the subject, taxpayer's counsel replied (R. 263): "Not entirely new, unless it is required by the Court"; and that he was depending on the evidence then in the record, which consisted only of Exhibit 51, the balance sheet as of December 31, 1935 (R. 264). In fact, all counsel wanted was that the Tax Court "take into consideration the facts already in the record and take that 1942 Act into consideration" (R. 265), and did not "think any

additional memorandum is necessary under the circumstances, as the facts are in evidence now" (R. 267). With the unexplained balance sheet the only evidence in the record, the Tax Court on July 30, 1943, in modifying and supplementing its order of December 4, 1942, on other issues, in effect rejected taxpayer's assertion that it was entitled to the deficit credit. (R. 270.) Revised recomputations were ordered filed, and taxpayer again presented the applicability of Section 26 (c) (3), with no suggestion that additional evidence might be necessary. (R. 273.) The matter was heard on January 5, 1944 (R. 298), and decided adversely to taxpayer on January 24, 1944 (R. 285). Taxpayer again, on February 17, 1944, attacked the order, this time on the ground that the Tax Court did not consider the applicability of Section 26 (c) (3) and that additional evidence which would be "an analysis of the Deficit Account" would be submitted. (R. 287.) It is from the denial of this motion for rehearing that taxpayer prosecutes the appeal on this phase of the case. But the only additional evidence offered by the motion is an analysis of the deficit account. Nothing newly discovered since the hearing on the issue on May 5, 1943, is suggested. As the Tax Court said (R. 300):

The record evidence has, upon the earlier presentations of the question, been found insufficient to show right to the deficit corporation credit. In the light of the entire record here, and after repeated presentation and consideration of this question, no just reason is found to vacate the decision of January 24,

1944, and the petitioner's motion is therefore denied.

Thus, after the hearing on May 5, 1943, the Tax Court considered the question of the deficit credit in its July 1943 and January 1944 orders, and in its February 1944 denial of taxpayer's motion for rehearing. It is clear why the evidence establishing the right to this credit was found wanting, for the balance sheet in no way demonstrates that the alleged deficit was in accumulated earnings and profits, or that taxpayer was in any way prohibited under California law from paying dividends in 1936.

Section 26 (c) (3), being a credit provision, must be narrowly construed. In order to claim the benefit of the credit, the taxpayer has the burden of showing strict compliance with its terms. *Helvering v. Northwest Steel Mills*, 311 U. S. 46. And where the taxpayer must rely on state law, he must establish it by a clear and convincing proof. *Helvering v. Fitch*, 309 U. S. 149, 156. We must remember that taxpayer is a wasting asset corporation. The California court, in an early decision, held that the then California statute (Civil Code, Sec. 309), which forbade withdrawal of capital or "capital stock" and confined dividends to "surplus profits arising from the business", did not forbid a mining corporation from distributing the net proceeds of its mining operations without provision for depletion, although the necessary result was that something was subtracted from the value of the mine and from the net worth of the investment. *Excelsior Min. Co. v. Pierce*, 90 Cal. 131. The present act (Sec. 346) in-

corporates this decision, subject to adequate provision for meeting debts and liabilities and liquidation preferences of outstanding shares. On October 28, 1936, taxpayer received from the trustees in the *Julian v. Schwartz* litigation, \$112,000 in cash (R. 193), and \$17,852.13 paid to the receiver (R. 194). By its own figures, including \$17,574.68 as a receivership expense in 1936, its net income was \$119,338.82 (R. 196), and its liabilities totaled only \$43,789.66.

Taxpayer has not shown it could not have paid the cash dividend from these net earnings, or if it could not, the amount of credit to which it was entitled. Since the preceding accounting period under Section 346 (2) of the California Code may be between six months and one year, and a dividend may be paid from earnings in such period despite the existence of a deficit, the Tax Court surely was not in error in holding that taxpayer had not met the burden of proof that a dividend could not have been paid at the end of December 1936 from the \$112,000 in cash received from the trustees in October 1936. And on the balance sheet which portrays the deficit of \$172,161.65, a reserve for depletion and depreciation is shown in the amount of \$99,979.87. (R. 103.) From a bare appraisal of the balance sheet, to the extent this reserve entered into the amount of the deficit, it must be eliminated, since under California law an impairment of assets based on depletion or depreciation of a wasting asset corporation is no restriction on the issuance of dividends. Neither the right to nor the amount of the credit was proven.

## III

**Taxpayer expressly waived raising and is not entitled to a rehearing to question the disallowance of additional receivership expenses for 1936**

Taxpayer attempts to question on this appeal the propriety of the Commissioner's disallowance of \$11,908.53 as additional receivership expenses for the taxable year 1936. In the notice of deficiency (R. 41), the Commissioner stated that \$11,908.52 of a total of \$17,852.13 claimed as receivership expenses were "disallowed for the reason that these expenses properly accrued prior to the taxable year" (R. 46). Although this matter was put in issue by the pleadings (R. 53) at the trial before the Tax Court, counsel for taxpayer specified that there were five issues involved in the cause, none of which was the question of the receivership expenses, and that counsel for the Commissioner was "correct" in presuming that the other issues set forth in the petition were "waived" (R. 108). The Tax Court then stated (R. 108):

\* \* \* before you start, you speak about others being waived. I was wondering about that, because there are a large number enumerated here. Are they waived or have some of them been disposed of in your stipulation?

To which taxpayer's counsel replied: "No. They have been waived. They are small items." (R. 108.) The question was not discussed in the briefs or at the hearing under Rule 50. (R. 297.) It is elemental that taxpayer is therefore precluded from raising the question of receivership expenses on this appeal.

*Commissioner v. Fortney Oil Co.*, 125 F. 2d 995 (C. C. A. 6th).

But an examination of the evidence and stipulation clearly shows why the Tax Court cannot be convicted of error in accepting taxpayer's waiver at face value. The claim is obviously without merit. In and after 1933, pursuant to a stipulation filed with the state court having jurisdiction over the trustees in the *Julian v. Schwartz litigation*, there were released to J. A. Smith for the account of taxpayer, proceeds of gas production from Wells Nos. 1, 2, 3 and 11. (R. 84, 196.) At the hearing in Washington, D. C., in 1937, with the representatives of the Bureau of Internal Revenue, the parties agreed that these proceeds would be income taxable to taxpayer, in and after 1933, as having been constructively received by it in the years when Smith was paid. (R. 84, 196.)<sup>6</sup> From this income, however, there were allowed as deductions, depreciation on the tangible equipment and business expenses paid and incurred, including legal fees and receivership expenses. (R. 85, 196-197.) The receivership expenses were allowed to the taxpayer as deductions "in and for the years in which they were definitely determined and approved by the Court", which had jurisdiction over the receiver. (Italics supplied.) (R. 85.) It should be noted that the expenses were to be allowed as deductions for the years the court approved them as proper, not as taxpayer asserts (Pet. Br. 34) for and in the

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<sup>6</sup> \$2,702.66 in 1933; \$2,498.47 in 1934; \$2,237.90 in 1935.

year the court did the approving. On November 12, 1936, the receiver filed with the state court a petition for approval to pay receiver's expenses, aggregating \$17,852.12. An examination of the petition shows (R. 197) that it specified the incurrence of expenses for the years 1931 to and including 1936, with the exception of 1935.<sup>7</sup> The court approved the account the day it was filed. (R. 198.) Thus, according to the stipulation and arrangement with the Bureau of Internal Revenue, the greater portion by far of these expenses was allowed as deductions in the years prior to 1936. For almost all the out of pocket expenses and a large percentage of the legal and receiver's fees were for services rendered for years prior to 1936 and rightfully approved by the court for those prior years. Taxpayer presumably has already taken the benefit of these deductions in computing its taxable income for these prior years, and cannot now obtain a double benefit by the allowance of the deductions again for the year 1936.

Taxpayer's claim that the Tax Court did consider the question of the receiver's expenses is a play on words. It is true that the court in denying taxpayer's motion of February 17, 1944, for rehearing, said (R. 296-297) :

All of the matters presented by the present motion had, prior to the filing thereof, been

<sup>7</sup> A further breakdown of receiver's fees shows them to include \$2,893.32 as balance due from the order of the court dated February 1, 1932, and \$3,500 for services rendered January 1, 1934 to December 1, 1936, by order of the court. This totals the \$6,393.32 mentioned by the Tax Court for 1936. (R. 197.)

thoroughly considered. On December 4, 1942, motion filed September 17, 1942, for rehearing, including consideration of the issues now raised as to loss on Well No. 16 and insolvency, was denied. The matter of receivership expense was waived at the original hearing, and was not discussed in petitioner's briefs nor at the hearing under Rule 50. The above issues were nevertheless reconsidered because the figures involved were incorporated in the recomputations submitted.

This in no way means that the Tax Court considered the merits of the receivership expense deduction. Despite the express waiver, taxpayer continued to submit for computation of the tax under Rule 50, recomputation statements incorporating the \$11,908.53 as an additional deduction. (R. 250, 275.) If the Tax Court looked at the statements at all, it had to consider this figure. It did so, by disallowing the deduction every time it was claimed. Taxpayer expressly waived attacking this item, and no merit lies in the claim. The additional receivership expense was properly disallowed for the taxable year 1936.

#### IV

**Taxpayer has not sustained the burden of proving the amount of any loss sustained in the relinquishment or exchange of its one-half interest in Well No. 16 in 1937**

At the outset, it must be emphasized that the amount of the loss sustained in the relinquishment or transfer of taxpayer's one-half interest in Well No. 16 is limited for taxation purposes to \$2,000. For the transaction whereby taxpayer quitclaimed its interest

in the well in 1937 to Smith constituted a sale or exchange of a capital asset within the meaning of Section 117 (d) of the Revenue Act of 1936. (Appendix, *infra*.) There can be no doubt that the well was a capital asset (Section 117 (a)), and an analysis of the transaction can likewise leave no doubt of its sale or exchange character.

Under the terms of the United lease (Ex. 26), taxpayer was required to operate Well No. 16 even though in doing so it sustained losses (R. 124, 199). It had sustained an operating loss of \$3,258.78 in the operation of the well in 1937 up to the time the well ceased producing because of some unknown damage. (R. 199.) Work of an undisclosed nature was necessary to ascertain the kind and extent of the damage and the cost of making repairs, and Smith, the owner of the other half interest, was not liable for more than \$250 per month for operating expenses. (R. 117, 124, 199.)

The choices were clear. Taxpayer could continue operating the well at a loss (R. 139, 140), which was immediately cast aside. Or it could abandon the well. In the event taxpayer did this, the lessors under the United lease had the right to come in and take possession of the well and equipment and operate it free from any claim of taxpayer, with the exception of a royalty of  $8\frac{1}{3}\%$ . (R. 199.) But there was no assurance the lessors would exercise their rights under the lease to take over the abandoned well. In fact, it appeared likely that they too would not desire to operate it at a loss and there was no reason to expect they

would be more successful at the operation than taxpayer. Thus, in order for taxpayer to elect to abandon the well, it had to assume that it would be obligated under the terms of the lease, to restore the premises to the original condition, and under the laws of California, to condition and plug the well for purposes of abandonment. (R. 134, 199.) It is well settled that a gas, oil, or petroleum well cannot merely be abandoned in California. It has to be conditioned for this purpose to the satisfaction of the Commissioner. Act No. 4916, Sec. 16, General Laws of California (1931, 1937). And this is likely to entail expenditures of substantial sums of money, in the case of Well No. 16, from \$5,000 to \$10,000. (R. 134, 199.)

But a third choice was open to taxpayer—to surrender its interest in the well to Smith. This would have two effects. It would release taxpayer from any personal liability for conditioning the well for abandonment, and relieve it from the terms of a very undesirable contract connected with its operation. As taxpayer in its brief says (Br. 36):

By quitclaiming to Smith, petitioner relieved itself of an onerous liability. Under the terms of its 1928 agreement petitioner was required to operate the well, even at a loss, so long as it retained possession. [R. 124, 126.] It undoubtedly chose the course of wisdom in surrendering the well to Smith, for although the well produced over \$15,000 worth of oil in 1938 [R. 132-3], as compared with only about \$10,000 in 1937 [R. 151], production then declined to about \$700 or \$800 a month [R. 133],

and even if petitioner had been able to put the well back on production at a cost of as little as \$500, it would have sustained a loss in operating the well because of the limitation on Smith's share of expenses [R. 139-140]. Furthermore, in quitclaiming the well to Smith, petitioner shifted to him the ultimate liability for conditioning the well for abandonment in compliance with state law. This might have cost between \$5,000 and \$10,000 [R. 134]. By quitclaiming to Smith, petitioner surrendered its interest in the well without incurring this liability.

A loss sustained by a mortgagor or a purchaser under a land contract from a voluntary surrender of the property to the mortgagee or seller *for the release of his personal liability* results from a sale or exchange. *Rogers v. Commissioner*, 103 F. 2d 790 (C. C. A. 9th); *Kaufman v. Commissioner*, 119 F. 2d 901 (C. C. A. 9th); see also, *Helvering v. Hammel*, 311 U S. 504. Taxpayer voluntarily surrendered its interest in Well No. 16 to Smith. By doing so it was released from any liability to condition the well for purposes of abandonment. This was a motivating factor of the transaction. (R. 134.) Taxpayer thus definitely received a *quid pro quo* from the transfer, and Smith took the whole interest in Well No. 16, burdened with the liability of conditioning it in the event of abandonment. This constituted a sale or exchange of a capital asset within the limitation provision of Section 117 (d).

But this question is rendered academic since, as the Tax Court held, the evidence of record fails to prove

the amount of any loss sustained by taxpayer in this connection. (R. 213.) Although in the notice of deficiencies the Commissioner disallowed the loss "as not falling within the provisions of section 23 of the Revenue Act of 1936" (R. 50), and counsel in his opening remarks questioned the bona fides of the transaction, the amount of the loss was expressly put in issue during the testimony of the first witness (R. 119) and thereafter throughout the hearing. The sole evidence introduced was Exhibit 57 (R. 157), which was offered (R. 155)—

for the purpose of showing the method and the manner in which petitioner arrived at the figure \$43,151.96 which the petitioner has claimed to have sustained as a loss on Well No. 16 at the time it was abandoned in 1937 and *not for the purpose of showing that it is evidence of the fact that they did sustain that*, but to show how we arrived at that figure, to show our method of computing. [Italics supplied.]

Taxpayer asserts (Pet. Br. 39) that if this were admitted just to show the method of computation, it would have been entirely immaterial. So counsel for the Commissioner thought when he objected to the offer on just this ground (R. 156) and the Tax Court in overruling the objection explained "It may not be highly material" but that it might still be helpful for the purpose offered. (R. 156.) The record belies the suggestion that the only reason the exhibit was objected to was that it contained a disputed element of depletion. (Pet. Br. 40.) With the examination of the first witness taxpayer was ap-

prised at the outset that it was charged with proof of the cost or other basis of the well for purposes of ascertaining the amount of any loss sustained. Yet it went through the entire hearing without introducing any substantive evidence of the amount of its loss.

The record is thus barren of any evidence upon which the Tax Court or this Court could base a finding of the adjusted basis of the well. After the Tax Court denied taxpayer's first motion for rehearing on this issue (R. 297), taxpayer in a period of more than one year, filed two recomputation statements, which apparently accepted the decision. Then in the final motion for rehearing (R. 286), the matter was again raised and denied (R. 297). There was no abuse of discretion by the Tax Court in its refusal to open the case and retry this issue of the adjusted basis of Well No. 16 for purposes of determining the amount of the loss. *Jankowsky v. Commissioner*, 56 F. 2d 1006 (C. A. A. 10th).

Taxpayer's attack upon the statements of the Tax Court on the interpretation of the figures in Exhibit 57, *were they in the record as such*, is in vain. At most, this analysis by the Tax Court was a gratuitous undertaking to show taxpayer that the mere fact it proved the book entries proved very little. See *Rieck v. Heiner*, 25 F. 2d 453 (C. C. A. 3d). Since the adjusted basis was contested, there is no doubt taxpayer would have to demonstrate that for taxation purposes the amounts portrayed represent the correct figures for depreciation and that intangible drilling costs had not been deducted as expenses in the years in which they were incurred, as permitted by the

Treasury Regulations.<sup>8</sup> For taxpayer was the assignee of part of the leasehold interest which Barnhart acquired under the United lease and which obligated Barnhart to drill. When taxpayer drilled Well No. 16, it was therefore developing its own lease and the expenses incurred were properly deductible at taxpayer's option. See *Hardesty v. Commissioner*, 127 F. 2d 843 (C. C. A. 5th).

#### CONCLUSION

There was no abuse of discretion in denying the taxpayer's motion for rehearing and the decision of the Tax Court should be affirmed.

Respectfully submitted,

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OCTOBER 1944.

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<sup>8</sup> See, for example, Regulations 74, promulgated under the Revenue Act of 1928, Art. 243.

## APPENDIX

Revenue Act of 1936, c. 640, 49 Stat. 1648:

### SEC. 14. SURTAX ON UNDISTRIBUTED PROFITS.

\* \* \* \* \*

(d) *Exemption from surtax.*—The following corporations shall not be subject to the surtax imposed by this section:

\* \* \* \* \*

(2) Domestic corporations which for any portion of the taxable year are in bankruptcy under the laws of the United States, or are insolvent and in receivership in any court of the United States or of any State, Territory, or the District of Columbia.

\* \* \* \* \*

### SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) *Expenses.*

(1) *Trade or business expenses.*—

(A) In General.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business,

\* \* \* \* \*

(f) *Losses by corporations.*—In the case of a corporation, losses sustained during the taxable year and not compensated for by insurance or otherwise.

\* \* \* \* \*

(h) *Basis for determining loss.*—The basis for determining the amount of deduction for losses sustained, to be allowed under subsection (e) or (f), shall be the adjusted basis provided

in section 113 (b) for determining the loss from the sale or other disposition of property.

\* \* \* \* \*

(j) *Capital losses.*—Losses from sales or exchanges of capital assets shall be allowed only to the extent provided in section 117 (d).

\* \* \* \* \*

#### SEC. 26. CREDITS OF CORPORATIONS.

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

\* \* \* \* \*

(c) [as amended by Section 501 of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Restrictions on payment of dividends.*—

\* \* \* \* \*

(3) *Deficit corporations.*—In the case of a corporation having a deficit in accumulated earnings and profits as of the close of the preceding taxable year, the amount of such deficit, if the corporation is prohibited by a provision of a law or of an order of a public regulatory body from paying dividends during the existence of a deficit in accumulated earnings and profits, and if such provision was in effect prior to May 1, 1936.

\* \* \* \* \*

#### SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

\* \* \* \* \*

(b) *Adjusted basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

\* \* \* \* \*

## SEC. 117. CAPITAL GAINS AND LOSSES.

\* \* \* \* \*

(b) *Definition of capital assets.*—For the purposes of this title, "capital assets" means property held by the taxpayer (whether or not connected with his trade or business) but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

\* \* \* \* \*

(d) *Limitation on capital losses.*—Losses from sales or exchanges of capital assets shall be allowed only to the extent of \$2,000 plus the gains from such sales or exchanges. If a bank or trust company incorporated under the laws of the United States or of any State or Territory, a substantial part of whose business is the receipt of deposits, sells any bond, debenture, note, or certificate or other evidence of indebtedness issued by any corporation (including one issued by a government or political subdivision thereof), with interest coupons or in registered form, any loss resulting from such sale (except such portion of the loss as does not exceed the amount, if any, by which the adjusted basis of such instrument exceeds the par or face value thereof) shall not be subject to the foregoing limitation and shall not be included in determining the applicability of such limitation to other losses.

\* \* \* \* \*

Civil Code of California (Deering, 1933 Supp.):

SEC. 346. CASH OR PROPERTY DIVIDENDS.—A corporation may declare dividends payable in cash or in property only as follows:

(1) *Out of earned surplus;* or

(2) Despite the fact that the net assets of the corporation amount to less than the stated capital, out of net profits earned during the preceding accounting period which shall not be less than six months nor more than one year in duration; or

(3) Out of paid-in surplus or surplus arising from reduction of stated capital subject to the provisions of section 348b, Civil Code, only upon shares entitled to preferential dividends; provided that notice shall be given to the shareholders receiving such dividends of the source thereof prior to or concurrently with the payment thereof.

*If the value of the net assets amounts to less, through depreciation, depletion, losses, or otherwise, than the aggregate amount of stated capital attributed to shares having liquidation preferences, the corporation shall not declare dividends out of net profits pursuant to subdivision (2) of this section, except upon such shares, until the value of the net assets has been restored to such aggregate amount of the stated capital attributed to outstanding shares having liquidation preferences.*

*No dividends shall be declared when there is reasonable ground for believing that thereupon the corporation's debts and liabilities would exceed its assets, or that it would be unable to meet its debts and liabilities as they mature.*

*No dividends shall be declared out of the mere appreciation in the value of its assets not yet realized, nor shall any dividends be declared from earned surplus representing profits derived from an exchange of assets unless and until such profits have been realized or unless the assets received are currently realizable in cash.*

*A wasting asset corporation, that is a corporation engaged solely or substantially in the exploitation of mines, oil wells, gas wells, patents or other wasting assets, or organized solely or*

substantially to liquidate specific assets, may distribute the net income derived from the exploitation of such wasting assets or the net proceeds derived from such liquidation without making any deduction or allowance for the depletion of such assets incidental to the lapse of time, consumption, liquidation or exploitation; subject, however, to adequate provision for meeting debts and liabilities and the liquidation preferences of outstanding shares and to notice to shareholders that no deduction or allowance has been made for such depletion. \* \* \*

No. 10806.

IN THE

United States Circuit Court of Appeals  
FOR THE NINTH CIRCUIT

---

BARNHART-MORROW CONSOLIDATED,

*Petitioner,*

*vs.*

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

---

REPLY BRIEF OF PETITIONER.

---

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NOV 13 1944

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## REPLY BRIEF OF PETITIONER.

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### I.

During the Year 1936 Petitioner Was Insolvent Within the Meaning of Section 14(d)(2) of the Revenue Act of 1936.

In determining whether petitioner was insolvent at the beginning of 1936 it must be remembered that the purpose of the inquiry is to ascertain whether petitioner should be subjected to a penalty in the form of a surtax for not distributing profits received in November of that year. That Congress intended to be liberal in relieving distressed corporations from that penalty is shown by the fact that it exempted corporations which *for any portion of the taxable year* were in bankruptcy or insolvent and in receivership.

This liberal intent was given recognition in *United States v. Anderson Co.* (C. C. A. 7), 119 F. (2d) 343, where the taxpayer was held insolvent in 1936 despite earnings of \$70,000.00 for the full year and a large preponderance of current assets over current liabilities, solely because its borrowing capacity was impaired by operating losses during a few months.

In *Artesian Water Company v. Commissioner* (C. C. A. 9), 125 F. (2d) 17, it appeared that the taxpayer had fixed assets greatly exceeding its liabilities, that it had a net income of \$54,101.14 for the tax year in question, and that during the year it actually paid off \$83,000.00 of its mortgage indebtedness of \$183,250.00. This Honorable Court nevertheless held that the corporation was insolvent because it was unable to pay the balance of the mortgage indebtedness at maturity "either from its *current assets*" or with the reasonable use of its credit. In a footnote at the bottom of page 22 of their brief, counsel for respondent submit "that the *Artesian Water Co.* case cannot be interpreted categorically to mean that the corporation as distinguished from the receiver must be able to satisfy creditors." This is precisely what was held in that case. Although the receiver's attempts to re-finance the mortgage had been unsuccessful because of questions raised as to his authority, there was nothing to indicate that he could not have obtained the necessary authorization; yet the Court said:

"As stated above, *all* of the taxpayer's income bearing assets were pledged to the Insurance Company as security for the loans, and in view of the receivership *taxpayer's* hands were just as effectively tied as if it had been in bankruptcy." (Emphasis supplied.)

In the instant case all of petitioner's income bearing assets were held by trustees appointed in the case of *Julian v. Schwartz*. While the income received by the trustees could be used to pay current operating expenses, it could not be used to pay prior indebtedness of petitioner, for until the final determination of the case it remained an open question whether petitioner had any title to these assets or to the income derived therefrom. Furthermore, all of petitioner's remaining assets, such as they were, were held by Armour as receiver. Clearly, just as in the *Artesian Water Co.* case, petitioner's hands were as effectively tied as if it had been in bankruptcy.

The Tax Court accepted respondent's contention that petitioner was solvent if its debts could have been paid by the *receiver*, and then proceeded to assert that capital stocks carried at about \$220,000.00 could have been sold or used as security for a loan to pay debts. The major portion of the discussion in our opening brief is devoted to showing that the capital stock in question was not stock of other corporations but was a mere bookkeeping item representing a type of promotion stock issued by petitioner. Counsel for respondent now recognize that the Tax Court made a glaring error, but argue that this is "unimportant" (Resp. Br. p. 21) for two reasons:

First, it is asserted that there is no proof of matured obligations. Counsel argue, for example, that accounts payable, standing substantially unchanged for two years, may not have become due. "Accounts payable" are defined in Webster's New International Dictionary as "balances at present due to others on current accounts." We submit that "accounts payable" are always matured obligations,

as are also "accrued taxes", "accrued payroll" and sums "due to stockholders."

Second, counsel argue that the receiver was able to "meet" these obligations by securing extensions of time from petitioner's creditors. To this argument there are several answers. To begin with, there is no suggestion in the record of any voluntary extension of time for payment by any creditor prior to October 28, 1936.

Counsel are mistaken in asserting (Resp. Br. p. 20) that Hardison had "previously" agreed to accept \$7,000 in settlement of his claims. Those claims were not settled until December 11, 1936 [R. 192-3]. In view of the fact that an adverse decision in the case of *Julian v. Schwartz* would add to petitioner's obligations the duty of accounting for the proceeds of past production [R. 98-99], neither petitioner nor the receiver had any credit whatsoever until that case was finally determined.

Moreover, the statement of this Court in the *Artesian Water Co.* case that a corporation is solvent if it can "meet" its obligations does not imply that solvency may be achieved merely by inducing creditors to refrain from filing actions. Surely one does not "meet" his obligations by "stalling" his creditors! The Senate Finance Committee's report on Section 14 (d) (2) (C. B. 1939-1, Pt. 2, p. 687) defines cases in which a corporation is insolvent as those in which "its liabilities are in excess of its assets or it is unable to *pay* the claims of creditors *as they mature.*" It is established by the uncontradicted testimony of Harold C. Morton in this case that until October 28, 1936, petitioner was "without funds to pay their obligations or to conduct their affairs." [R. 119-120].

II.

**Petitioner Was Entitled, in Computing Its Undistributed Net Income for 1936, to Deduct Its Deficit as of December 31, 1935.**

The statement of counsel for respondent that petitioner "had full opportunity to adequately present its case before the Tax Court, and voluntarily and expressly chose to have the issue of the deficit credit decided on the record as it then stood" (Resp. Br. p. 23) was anticipated in our opening brief and fully refuted on pages 18-20. We will not repeat what was said in that brief, except to point out that the Tax Court first refused to permit the introduction of evidence at the hearing on recomputation and then denied a rehearing because the evidence offered was not newly discovered. Respondent is now lending support to what amounts to a denial of due process of law.

The fact that petitioner is a "wasting asset corporation", as that term is defined in the last paragraph of Section 346 of the Civil Code, does not, as suggested by opposing counsel (Resp. Br. pp. 26-27), render inapplicable the restrictions on payment of dividends contained in the first paragraph of that section. Section 346 permits payment of dividends either out of surplus *or* out of profits. As pointed out in *Ballantine, California Corporation Laws*, pp. 338-9, the section adopts both the "earned surplus rule" and the "net profits rule", earned surplus being the accumulated earnings or balance of profits since incorporation, and net profits the net income for a given period. The last paragraph merely permits *net profits* to be de-

terminated, in the case of a wasting asset corporation, without deduction for depletion (*Ballentine, supra*, p. 349). It has no effect in the determination of whether or not there is an earned surplus; consequently, petitioner's \$172,161.65 deficit is not reduced by prior depletion, much less by the total of almost \$100,000.00 set aside for depletion *and depreciation*.

In November, 1936 [R. 198-9] petitioner received \$112,000.00 from the trustees. Counsel for respondent conjure up the possibility that petitioner might therefore have been able to pay dividends in December "out of net profits earned during the preceding accounting period", within the meaning of Section 346 (2). In the first place, petitioner's accounting period was the calendar year [R. 193, 254, 279]. Petitioner could not arbitrarily have created a new period ending in November for the sole purpose of declaring a dividend, for the privilege of paying profits out of earnings during a special "dividend period" was eliminated by the 1933 amendment to Section 346. In the second place, petitioner was in any event prohibited from paying dividends during the first ten months of 1936 because of the continued existence of the deficit and therefore qualifies under Section 26 (c) (3) of the Revenue Act of 1936 as a corporation prohibited by law from paying dividends during the existence of a deficit.

In their brief, at page 26, counsel for respondent say that "the balance sheet in no way demonstrates that the

alleged deficit was in accumulated earnings and profits." True, but it constitutes at least *prima facie* evidence of that fact. A *demonstration* was what petitioner sought to make by presenting to the Tax Court on rehearing an analysis of the deficit account [R. 287], but petitioner was not given the opportunity. It seems clear, therefore, that if the balance sheet is not given full weight as *prima facie* evidence of a deficit in accumulated earnings and profits, it was an abuse of discretion and reversible error to deny petitioner the right to prove the deficit by further evidence.

### III.

#### Petitioner Was Entitled to Deduct Receivership Expenses Paid in 1936 in Determining Its Net Income and Undisputed Net Income for That Year.

On the question of waiver, counsel for respondent cite *Commissioner v. Fortney Oil Co.* (C. C. A. 6), 125 F. (2d) 995, where the court said of certain questions raised by the taxpayer:

"These questions were not considered by the Board, are not presented in the evidence, and cannot be considered here."

In the instant case the question as to petitioner's right to deduct receivership expenses *was* presented in the evidence [R. 83-5] and, despite the inadvertent statement of counsel for petitioner with respect to waiving all but certain issues, *was* considered by the Tax Court on petitioner's

motion for rehearing [R. 296-7]. As stated in our opening brief, page 33, we believe the issue is before this Honorable Court on its merits.

Respondent's argument on the merits is that the stipulation [R. 85] that receivership expenses were allowed as deductions "in and for the years in which they were definitely determined and approved by the Court in said cause of action No. 325061 wherein the said Ralph S. Armour was receiver" means that the receivership expenses were recognized as deductions "for the years the court approved them as proper" (Resp. Br. pp. 29-30) —that is, the years when the expenses were incurred by the receiver, as shown by the account approved by the court. This is an obvious misconstruction of the stipulation. The only years referred to in the stipulation are "the years *in which* they [the receivership expenses] were approved by the Court." The state court had no concern with the years in which particular expenditures might be deductible for tax purposes; it merely approved the account rendered by the receiver and directed payment of his expenses as stated therein [R. 198]. The years in which such approvals were given, however, were those adopted at the hearing in Washington on August 13, 1937 as fixing the time for deduction of the receivership expenses.

In a footnote at page 30 of their brief, counsel for respondent say that the receivers fees approved by the state court on November 12, 1936 [R. 197] included a \$2,893.32 balance of fees due under an earlier court order. We do not know the source of counsel's information of this fact, if it is a fact; but certainly it does not appear in the record.

#### IV.

#### **Petitioner Sufficiently Established the Loss Sustained in 1937 on Surrender of Well No. 16.**

Counsel for respondent argue at some length (Resp. Br. pp. 31-34) that because the relinquishment of petitioner's interest in Well No. 16 relieved petitioner of the statutory burden of conditioning the well for abandonment, the transfer to Smith amounted to a "sale or exchange" within the meaning of Section 117(d) of the Revenue Act of 1936, and that the loss was therefore limited as a deduction to \$2000.

It should be noted at the outset that although Section 16 of the Oil and Gas Conservation Law (Act 4916, General Laws of California) imposes upon the operator of a well a duty which may entail considerable expense, and this duty may be referred to as a statutory liability, it is not a financial liability in the sense of an indebtedness upon which judgment may be recovered. By Section 21, non-compliance is made a misdemeanor, subject to penalty by fine and/or imprisonment.

Counsel for respondent rely upon decisions holding that a voluntary surrender of mortgaged property in consideration of release of personal liability for the mortgage indebtedness is a sale within the meaning of Section 117(d). In such cases, however, the grantor receives a consideration from the mortgagee which is personal and not merely incident to ownership of the property. Where there is no personal liability on the part of the grantor, but the property is merely held subject to the lien of the mortgage, the transfer to the mortgagee is held not to

constitute a sale. *Commissioner v. Hoffman* (C. C. A. 2), 117 F. (2d) 987; *Stokes v. Commissioner* (C. C. A. 3), 124 F. (2d) 335. These cases were distinguished, but approved as consistent with the latest Supreme Court decisions, in *Commissioner v. Green* (C. C. A. 3), 126 F. (2d) 70, and *Myers*, 3 T. C. 1044.

Certainly the mere fact that a transfer is motivated by a desire to avoid the burdens of continued ownership cannot be sufficient to characterize the transfer as a "sale or exchange." As recently pointed out by the Supreme Court in *Helvering v. Williams Flaccus Oak Leather Co.*, 313 U. S. 247, 249, 85 L. Ed. 1310, 1312, these words in Section 117(d) must be given their "ordinary meaning." In *Stokes v. Commissioner*, *supra*, the court said:

"And if, as a last resort, it is urged that being rid of a piece of real estate which is a source of burden instead of benefit is a sale, then every transfer is equally within the terms of the statute, and 'sale or exchange' must be taken to mean 'sale or any other transaction by which an owner divests himself of property.' A court is not privileged thus to rewrite legislative language, even though it might think such substitutions better carry out the policy than the language actually used by the lawmaking body."

In the instant case, moreover, petitioner was not at the time of the transfer to Smith under any *present* burden or liability, statutory or otherwise. The mere avoidance of a *future* liability incident to continued ownership cannot constitute a consideration for the particular transfer actually made. This was recognized in *Aberle v. Commissioner* (C. C. A. 3), 121 F. (2d) 726, although the facts in that case showed that the liability had already accrued when the transfer was made. The transfer was made by

the mortgagors to the mortgagee under an agreement whereby the latter undertook to accept a deed before January 1, 1935, or else to indemnify the mortgagors against 1935 property taxes. The transfer was held to be a sale, but only because the evidence showed it took place after January 1, 1935. The same principle was applied in the case of *Charles Strub*, Mem. B. T. A., January 23, 1942, C. C. H., Dec. 12400G. In that case the petitioner had acquired by assignment a leasehold interest in certain Los Angeles real property and later, by agreement with the lessor, he gratuitously assigned this lease to the latter's nominee. The Board member pointed out that at the time of this re-assignment petitioner had no liability for future rents except such as arose from privity of estate and added:

“Since no covenants with regard to rental or otherwise were broken by him during the time the leasehold was held by him, there was no liability on his part running to the lessors which the lessors could, by any action on their part, release to petitioners. Therefore, there was no consideration moving to petitioners from the lessors in return for the re-assignment of petitioners' interest in the leasehold; and therefore such re-assignment can not be said to be a 'sale or exchange' of a capital asset within the meaning of Section 117(a), Revenue Act of 1934.”

We have anticipated in our opening brief, at pages 38-40, the arguments now advanced by counsel for respondent as reasons for disregarding Petitioner's Exhibit 57.

On the question whether the depreciation on tangible well equipment taken by petitioner is the full amount “allowable”, counsel cite *Rieck v. Heiner* (C. C. A. 3), 25

F. (2d) 453, as holding that book entries prove very little. In that case the Commissioner had recomputed the depreciation taken on the taxpayer's return; here the Commissioner challenged the entire loss claimed by petitioner and never even suggested that the depreciation deduction was too small.

With respect to the claim that petitioner *may have* deducted intangible drilling costs in prior years, we respectfully refer the Court to pages 45-47 of our opening brief. We repeat that under the decision in *Hardesty v. Commissioner* (C. C. A. 5), 127 F. (2d) 843, and other cases cited in our brief, petitioner was not given this right, because its agreement to drill the well was the consideration for an interest in the United Lease. The fact is they were *not* expensed, and petitioner was denied the opportunity to show this [R. 242].

### Conclusion.

We believe this is a case in which the Commissioner, in his zeal to collect revenue, has disregarded his equal duty to deal fairly with the taxpayer. In the absence of any question raised in the notice of deficiency as to petitioner's books and balance sheets, and in the absence of any challenge or contradictory evidence offered by the Commissioner at the hearing, petitioner is entitled to the full probative value of the evidence adduced; and if this is insufficient, it is respectfully submitted that petitioner should be given the opportunity at a further hearing to present any additional evidence which may be required.

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No. 10806.

IN THE

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---

BARNHART-MORROW CONSOLIDATED,

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**vs.**

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

---

**PETITION FOR REHEARING.**

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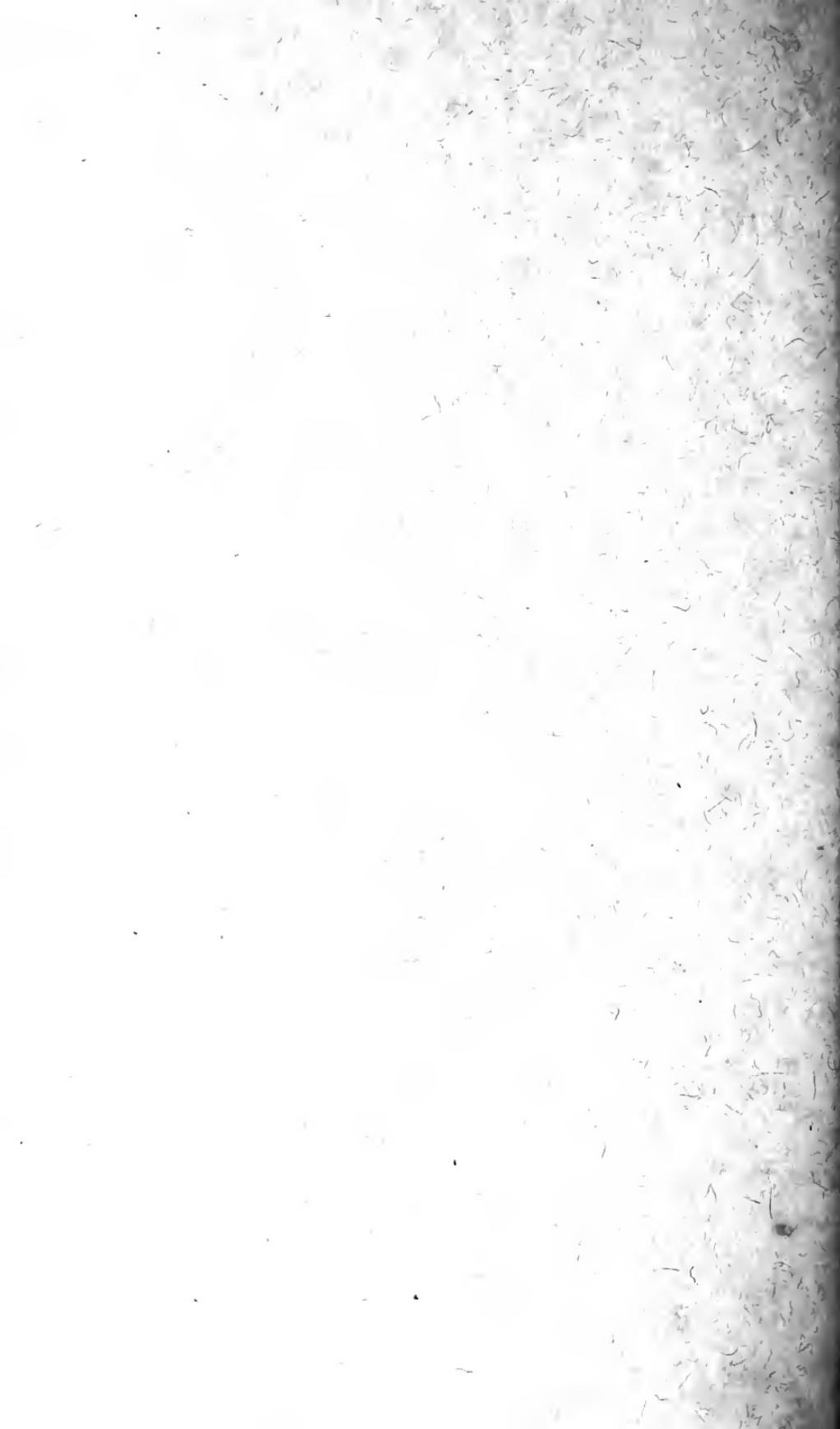
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**FILED**

JUL 23 1945

**PAUL P. O'BRIEN,**

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*Respondent.*

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**PETITION FOR REHEARING.**

---

*To the Honorable Justices of the United States Circuit Court of Appeals for the Ninth Circuit:*

The taxpayer, Barnhart-Morrow Consolidated, a corporation, respectfully presents its petition for a rehearing of the above entitled cause on the grounds hereinafter stated.

**I.**

**The Opinion of June 22nd Erroneously Decides the Issue as to Insolvency.**

On page 4 of the opinion, lines 7 to 10, the Court says that the balance sheet of petitioner "shows personal property in equipment, automobiles, etc., in value in excess of \$43,789.66, title to which is *not shown to be involved in the Julian v. Schwartz receivership.*"

This statement is entirely without foundation. The balance sheet [R. 194-5] lists "oil well machinery and equipment" and "automobiles and trucks" under the heading of "capital assets", all of which were held by the *Julian v. Schwartz* receivers. The Board of Tax Appeals found [R. 195]:

"The assets shown in the balance sheet as capital assets, except a well known as the Hartley Well (not carried as an asset after 1930), and office furniture and fixtures shown in the books after 1931 at a value of \$811.50, were not in the possession of petitioner from the time of the appointment of the receiver in 1931 until the final determination of the Julian v. Schwartz litigation in 1936, but were in the possession of the receiver in that litigation and were being claimed by Schwartz and the holders of participating oil agreements as asserted in the proceeding."

On page 5 of the opinion, lines 7 to 10, the Court says:

"Of the \$43,789.66, over \$15,000, supposedly owed to one Hardison, was abandoned by him in 1936; and \$7,000 of this sum was expressly admitted by him to be excessive accrued salary."

On October 28, 1936, when the *Julian v. Schwartz* judgment became final, the balance sheet included as a liability, under the heading "Accrued Expenses—Pay Roll" [R. 104], \$14,000 claimed by Guy Hardison. The Board found that it was not until December 11, 1936, that this claim was settled for \$7,000 [R. 192-3]. The remainder of the total of "over \$15,000" referred to in the opinion must be the \$8500 in promissory notes held by Hardison. But, as was pointed out in oral argument, *these notes were*

*not treated as liabilities after 1930* [R. 104, "Notes Payable"] and consequently do not enter into the total of \$43,789.66 in liabilities under consideration.

On page 5 of the opinion, lines 10 to 14, the Court says:

"But even if the statement of accrued liabilities be taken at face value, taxpayer's position is unsound. With its title to properties producing a net of \$265,-550, established in the Superior Court in 1933, taxpayer well could have a credit greatly in excess of its accrued liabilities."

This language is a direct repudiation of the common sense approach adopted in *Artesian Water Co. v. Commissioner*, 125 Fed. (2d) 17, where the Court said:

"As well put by the taxpayer in its brief, 'The solvency or insolvency of the petitioner, that is, its ability to pay its debts, must be determined in the actual situation in which the petitioner is found in the taxable year, and not in some false and assumed situation in which it is not found, for example, free from receivership.' "

The fact that the taxpayer had prevailed in the trial court in 1933 did not give it any standing as a borrower. The title to the disputed assets remained in question throughout the pendency of the appeal. Certainly this Court must realize that no one would lend money to a corporation whose solvency, even in the bankruptcy sense, depended upon the action of the Appellate Courts. The receipt of anything less than usurious interest could not begin to compensate the lender for the risk involved in such a loan. This would be true even if the pending action merely involved a dispute over the title to assets; but the case of

*Julian v. Schwartz* involved much more than that. An adverse decision on appeal would have added to the corporation's obligations the duty to account to third persons for the proceeds of past production [R. 98-99]. It seems clear to us that no one but a fool would lend money under such circumstances, and the corporation could have no credit whatsoever until the case was finally determined.

In the *Artesian Water Co.* case, the judgment in favor of the Commissioner was reversed because "all of the taxpayer's income-bearing assets were pledged . . . and in view of the receivership taxpayer's hands were just as effectively tied as if it had been in bankruptcy." Here the case for insolvency is much stronger. All of the taxpayer's assets were held by receivers—the income-producing assets by the receivers appointed in the *Julian v. Schwartz* case, and the remaining assets (office furniture and fixtures) by the receiver appointed in the *Morrow* case. And in addition to that, the title to the income-bearing assets was in dispute.

When the Board, in the opinion below, said that "no attempt was made to show inability to meet maturing debts by a reasonable use of credit" [R. 206], it was laboring under the impression that the taxpayer was required to show that the receiver (Armour), as distinguished from the corporation itself, was without credit, and that the receiver had securities carried at \$219,120.50 under his control. This Court, on the authority of the *Artesian Water Co.* case, has very properly recognized that the question is as to the borrowing capacity of the corporation, not the receiver, and has impliedly conceded, as does the Commissioner himself, that the assumed securities are non-existent; but the Court has now taken an extreme position

of its own, never even suggested by counsel for the Commissioner, that the corporation could borrow on the strength of its Superior Court judgment. Even the Board's opinion recognizes that the income-bearing assets were not available as security during the pendency of the appeal [R. 206]. The truth is that during the pendency of the appeal neither the corporation nor Armour as its receiver had any borrowing capacity whatsoever.

## II.

### **The Opinion of June 22nd Erroneously Decides the Issue as to the Deficit Credit Claimed by Taxpayer.**

On page 6, lines 2-11, of the opinion, the Court says:

"In taxpayer's computation, submitted on March 26, 1943, taxpayer suggested its right to this deficit credit; reference was made to the balance sheet of December 31, 1935, the only evidence in the record bearing upon the matter of a deficit 'as of the close of the preceding taxable year'. This shows an alleged deficit of \$172,161.65, but does not purport to indicate whether it is in accumulated earnings and profits in contrast, for example, to a deficit caused by distribution of capital to shareholders or wasting of natural resource assets, or other capital depletion such as by uninsured fire or breakdown of machinery."

In our opening brief, at page 23, we cite the District Court decision in *Byron Sash & Door Co. v. U. S.*, to show that no adjustment of the balance sheet deficit was necessary because of prior capitalization of earned surplus. In that case the balance sheet deficit of \$66,855.04 at the end of 1936 would have been a surplus of \$63,144.96

but for a \$130,000 stock dividend in 1929. In other words, in 1929 \$130,000 was transferred from the earned surplus account to the capital account, and a \$130,000 stock dividend was then declared. The court held that there was nevertheless a "deficit in accumulated earnings and profits" of \$66,855.04 within the meaning of Section 23(c)(3) of the Revenue Act of 1936. That decision has just been affirmed by the Circuit Court of Appeals for the Sixth Circuit in *United States v. Byron Sash & Door Company*, decided June 18, 1945 and reported in Prentice-Hall, 1945 Federal Tax Service at par. 72589. The Circuit Court of Appeals said:

"The Byron Company had a deficit in accumulated earnings and profits as of the close of the preceding taxable year and continuing for seven years before the current earnings of 1937, which in effect were impounded for the repair of its capital, and upon which the Commissioner levied the undistributed profits surtax. The trial court held that appellee was authorized by law to capitalize its accumulated earnings and profits, 'and thereby impress the assets so transferred with the same character as capital invested originally'

. . . . .

"We are in accord with the foregoing determination."

If a direct transfer of surplus to the capital account for the purpose of distribution to shareholders is irrelevant to the question as to the nature of a subsequent balance sheet deficit, certainly that question is not affected by other depletions of capital charged to the earned surplus account,

such as "wasting of natural resource assets" or "uninsured fire or breakdown of machinery", referred to in the opinion in this case. The decision of this Court is therefore in direct conflict with that of the Sixth Circuit Court of Appeals in the *Byron Sash & Door Co.* case.

The record [R. 104] shows a deficit of \$172,161.65 in the "surplus" account as of December 31, 1935. We know from the findings [R. 193] that at least \$103,243.89 of this was a deficit caused by operating losses during the years 1931-35. In the light of the *Byron Sash & Door Co.* decision, how can the taxpayer be denied a credit against undistributed profits in at least this amount of \$103,243.89? The report of that decision, which of course was not available to this Court at the time it filed the opinion in this case, should compel a reconsideration of this issue.

In our opening brief, at pages 18-20, and again in our reply brief, at page 5, we pointed out that the taxpayer was not permitted to introduce evidence as to the nature of the balance sheet deficit during the hearings under Rule 50. That rule expressly provides that:

"Any argument under this Rule will be confined strictly to the consideration of the correct computation of the deficiency or overpayment resulting from the report already made, and no argument will be heard upon or consideration given to the issues or matters already disposed of by such report or of any new issues. This Rule is not to be regarded as affording an opportunity for rehearing or reconsideration."

When the effect of this rule was pointed out by the Board member [R. 262-263], Mr. Meitner, appearing for the taxpayer, said [R. 264] "I am not proposing any new evidence unless the Court deems it proper, if new evidence is necessary to sustain that figure. *In other words, not now.*" As soon as the proceedings had passed beyond the scope of Rule 50, the taxpayer filed a motion for rehearing, offering new evidence in the form of an analysis of the deficit account [R. 287]. This was in accordance with *the Board member's own suggestion* [R. 263]. How, then, can it be said that the Tax Court was justified in refusing to permit the introduction of this evidence? The cases cited in the opinion, at page 7, certainly do not deal with a situation such as this, in which the taxpayer has in effect been denied his day in court.

We further submit that the Court's decision is in conflict with the case of *Bell v. Commissioner* (C. C. A. 3), 139 Fed. (2d) 147, cited at pages 24-25 of our opening brief. In that case the taxpayer raised a new issue by motion for reconsideration after entry of the Tax Court's decision, and it was held that the case had to be remanded because the Tax Court had merely denied the motion for reconsideration, without making any finding as to the facts relevant to the issue thus raised. That is precisely what has occurred in this case. The very least that should be required is that the Tax Court make a finding as to whether or not there is a deficit in accumulated earnings and profits.

### III.

#### **The Opinion of June 22nd Erroneously Decides the Issue as to Deduction of Receivership Expenses.**

It was stipulated [R. 83-84] that in connection with certain proposed additional assessments a hearing was held in Washington on August 13, 1937, at which hearing the net income or losses of the taxpayer were determined for the years *1930 to 1935, inclusive*. The stipulation further states that at the same hearing on August 13, 1937, certain gas revenues were determined to be income constructively received by the taxpayer "in the year 1933 and the years subsequent thereto"—that is, in 1933, 1934 and 1935 (but not in 1936, for the income for 1936 was not determined at the hearing). Finally, the stipulation declares [R. 84-85] that certain expenses were allowed as deductions from the income so constructively received, including receivership expenses, which "were allowed as deductions in and for the years in which they were definitely determined and approved by the Court in said cause of action No. 325061 wherein the said Ralph S. Armour was Receiver."

The Court, on page 8 of its opinion, says:

"Taxpayer contends that the last sentence is a stipulation that they were only to be used as deductions for the year 1936. Such a construction makes meaningless the entire portion of the stipulation referring to the tax years 1931 to 1935, inclusive."

This represents a misunderstanding of the taxpayer's contention. The stipulation did not deal with the year 1936, but only with the years 1930-1935. There had been approvals of receivership expenses in these earlier years, and the stipulation makes it clear that the expenses so approved had been allowed as deductions for the years in which approval had been given by the Court. The taxpayer contends merely that this stipulation evidences *a recognition by the Commissioner of the rule now contended for with respect to receivership expenses approved by the Court in 1936*—that is, that they should be allowed as deductions for the year 1936, notwithstanding the fact that the expenses were incurred in prior years. Incidentally, we are informed that none of these expenses approved in 1936 had been previously approved by the Court or deducted for income tax purposes, although there were approvals and deductions of *other* receivership expenses in prior years.

This issue has been decided on a mistaken impression as to the meaning of the stipulation and the nature of the taxpayer's contention. We respectfully request a decision on the merits and submit that the applicable principles of law are those stated in our opening brief at pages 33-34. It will be observed that these principles are not denied in the brief filed by counsel for the Commissioner.

IV.

**The Opinion of June 22nd Erroneously Decides the Issue as to Loss on Surrender of Well No. 16.**

The Court's opinion on this issue turns upon the fact that Exhibit 57 [R. 157-158], showing the amount of the loss on surrender of Well No. 16, was offered and admitted "for the purpose of showing the method and manner in which petitioner arrived at the figure \$43,151.96" and not for the purpose of showing that the taxpayer had actually sustained this loss [R. 155]. On pages 38-40 of our opening brief we carefully demonstrated, by references to the transcript, that this restriction was intended to relate only to the total of \$43,151.96 and the items of depletion (\$9407.29 and \$8050.80) shown on the exhibit, since those particular figures involved the question of depletion, which was an issue in the case; and that no restriction was intended or understood with respect to the other figures shown on the exhibit. We respectfully ask the Court to reread these pages, 38 to 40, of our opening brief.

In any event, however, Exhibit 57 was *not* the only evidence of the loss on Well No. 16. Mr. Meitner's testimony that the figures shown on Exhibit 57 were taken by him from the books of the corporation [R. 153] was equivalent to a statement of what the books showed. While the books themselves might be the best evidence of their contents, this testimony was certainly competent and should not be disregarded. It was the document admitted as Exhibit 57 which was offered and admitted for the

limited purpose of showing the method of computation.  
No such limitation applied to Mr. Meitner's testimony.

For the reasons above set forth we earnestly believe that the opinion should be vacated and a rehearing granted to the taxpayer.

Respectfully submitted,

HAROLD C. MORTON,  
LEON B. BROWN,

By HAROLD C. MORTON,

*Attorneys for Petitioner.*

---

#### Certificate of Counsel.

The undersigned hereby certify that in the judgment of each of them the foregoing Petition for Rehearing is well founded and that said petition is not interposed for delay.

HAROLD C. MORTON,  
LEON B. BROWN,

By HAROLD C. MORTON,

*Attorneys for Petitioner.*

No. 10809

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United States  
Circuit Court of Appeals  
For the Ninth Circuit.

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LAWRENCE W. BRADY,

Appellant,

vs.

UNITED STATES OF AMERICA,

Appellee.

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Transcript of Record

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Upon Appeal from the District Court of the United States  
for the Northern District of California,  
Southern Division

FILED

OCT 6 - 1944

PAUL P. O'BRIEN,  
CLERK



No. 10809

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United States  
Circuit Court of Appeals  
For the Ninth Circuit.

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LAWRENCE W. BRADY,  
Appellant,  
vs.  
UNITED STATES OF AMERICA,  
Appellee.

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Transcript of Record

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Upon Appeal from the District Court of the United States  
for the Northern District of California,  
Southern Division

diffusion

diffusion

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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in italic; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in italic the two words between which the omission seems to occur.]

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NAMES AND ADDRESSES OF ATTORNEYS

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Northern District of California.  
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San Francisco, California.

Attorneys for Plaintiff and Appellee.

In the Southern Division of the United States District Court for the Northern District of California.

## INDICTMENT

First Count: Jones-Miller Act, 21 USC 174:

In the March, 1944 term of said Division of said District Court, the Grand Jurors thereof, on their oaths, present: That

LAWRENCE W. BRADY, and  
MARGARET BRADY,

(hereinafter called "said defendant"), on or about the 4th day of April 19, 1944, in the City and County of San Francisco, State of California, within said Division and District, fraudulently and knowingly did receive, conceal, and facilitate the concealment of a certain quantity of a derivative and preparation of morphine, to-wit, a lot of heroin, in quantity particularly described as approximately one ounce and 13 grains of heroin, and the said heroin had been imported into the United States of America contrary to law, as said defendants then and there knew.

Second Count: Jones-Miller Act, 21 USC 174:

And the said Grand Jurors upon their oaths aforesaid do further present: That at the time and place mentioned in the first count of this indictment, within said Division and District, said defendants fraudulently and knowingly did facilitate the transportation of a certain quantity of a derivative and preparation of morphine, to-wit, a lot of heroin in quantity particularly described as ap-

proximately one ounce and 13 grains of heroin, and the said heroin had been imported into the United States of America contrary to law, as said defendants then and there knew.

FRANK J. HENNESSY

United States Attorney [1\*]

[Endorsed]: A true bill, Paul B. Fay, Foreman. Presented in Open Court and Ordered Filed Apr. 18, 1944. C. W. Calbreath, Clerk. By Edward A. Mitchell, Deputy Clerk. [2]

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District Court of the United States, Northern District of California, Southern Division

At A Stated Term of the Southern Division of the United States District Court for the Northern District of California, held at the Court Room thereof, in the City and County of San Francisco, on Thursday, the 20th day of April, in the year of our Lord one thousand nine hundred and forty-four.

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\*Page numbering appearing at foot of page of original certified Transcript of Record.

Present: The Honorable Michael J. Roche, District Judge.

No. 28520-R.

UNITED STATES OF AMERICA,

vs.

LAWRENCE W. BRADY and MARGARET  
BRADY,

**ARRAIGNMENT**

This case came on this day ex parte. The defendants Lawrence W. Brady and Margaret Brady were present in the custody of the United States Marshal and with their attorney, Sol A. Abrams, Esq. James T. Davis, Esq., Assistant United States Attorney, was present for and on behalf of the United States.

On motion of Mr. Davis, the defendants were called for arraignment. The defendants were informed of the return of the Indictment by the United States Grand Jury, and asked if they were the persons named therein, and upon their answer that they were, and that their true names were as charged, said defendants were informed of the charges against them and stated that they understood the same. Mr. Abrams waived the reading of the Indictment. On motion of Mr. Abrams and with consent of Mr. Davis, the Court ordered that the amount of bail be reduced to \$2500.00 for each defendant. Ordered case [3] continued to May 3, 1944, to plead. Further ordered that in default of

bail defendant so in default stand committed to the custody of the United States Marshal to await entry of plea and that a writ issue. [4]

---

**[Title of Court and Cause.]****PETITION TO QUASH ARRESTS AND  
FOR DISMISSAL**

Comes now the above named defendant Lawrence W. Brady and Margaret Brady, hereinafter called petitioners, and respectfully presents and petitions as follows:

That on or about the 4th day of April, 1944, in the City and County of San Francisco, State of California, and within the above Division and District, petitioners were arrested by Federal Narcotic Agents without a search warrant or warrant of arrest first had and obtained, without good or probable cause, and in violation of their Constitutional rights under the Fourth and Fifth Amendments of the Constitution of the United States.

Wherefore, your petitioners pray that an order be made quashing said arrests and dismissing petitioners.

**SOL A. ABRAMS**

Attorney for Petitioners

State of California,  
City and County of San Francisco—ss.

Lawrence W. Brady, being sworn, says: that he is one of the petitioners in the foregoing petition;

that he had read the foregoing petition and knows the contents thereof and the same is true of his own knowledge, except as to those matters which are therein stated upon his information and belief, and that as to those matters he believes it to be true.

**LAWRENCE W. BRADY**

Subscribed and sworn to before me this 28th day of April, 1944.

(Seal)           **LOUIS WIENER**

Notary Public in and for the City and County of San Francisco, State of California. [5]

State of California,  
City and County of San Francisco—ss.

Margaret Brady, being sworn, says: that she is one of the petitioners in the foregoing petition; that she has read the foregoing petition and the contents thereof are known to her and the same is true of her own knowledge, except as to those matters which are therein stated upon her information and belief, and that as to those matters she believes it to be true.

**MARGARET BRADY**

Subscribed and sworn to before me this 28th day of April, 1944.

(Seal)           **LOUIS WIENER**

Notary Public in and for the City and County of San Francisco, State of California.

[Endorsed]: Filed Apr. 29, 1944. [6]

## District Court of the United States, Northern District of California, Southern Division

At a Stated Term of the Southren Division of the United States District Court for the Northern District of California, held at the Court Room thereof, in the City and County of San Francisco, on Wednesday, the 3rd day of May, in the year of our Lord one thousand nine hundred and forty-four.

Present: The Honorable Michael J. Roche, District Judge.

[Title of Cause.]

No. 28520

ORDER DENYING MOTION TO QUASH ARREST AND FOR DISMISSAL; DEFENDANTS' PLEAS OF NOT GUILTY ENTERED

This case came on regularly this day for hearing the defendants' motion to quash arrest and for dismissal. The defendants Lawrence W. Brady and Margaret Brady were present with Sol A. Abrams, Esq., their attorney. James T. Davis, Esq., Assistant United States Attorney, was present for and on behalf of the United States. William H. Grady was sworn and testified on behalf of the United States. After hearing the arguments of Mr. Davis and Mr. Abrams, it is ordered that the motion to quash the arrest and for dismissal be and the same is hereby denied, and to which ruling of the Court an exception was noted.

The defendants were called to plead and there-upon each defendant pleaded "Not Guilty" to the Indictment filed herein, which said pleas were ordered entered.

After hearing the Attorneys, the Court ordered that this case be continued to May 9, 1944, for trial. [7]

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District Court of the United States, Northern District of California, Southern Division

At A Stated Term of the Southern Division of the United States District Court for the Northern District of California, held at the Court Room thereof, in the City and County of San Francisco, on Thursday the 9th day of May, in the year of our Lord one thousand nine hundred and forty-four.

Present: The Honorable Michael J. Roche, District Judge.

[Title of Cause.]

No. 28520

MINUTES OF TRIAL

This case came on regularly this day for trial. James T. Davis, Esq., Assistant United States Attorney, was present on behalf of the United States. The defendants Lawrence W. Brady and Margaret Brady were present with Sol A. Abrams, Esq., their attorney. Hugh J. Boone was sworn and testified regarding the custody of the exhibits in this case. Thereupon the following persons, viz:

W. H. Purcell	John E. Gustafson
Claus H. Offerman	Joseph C. Bray
Charles A. Anderson	Wayne L. Miller
Helen F. DePaoli	Raymond W. Ring
Albert L. Hammill	William Fisher
Augustine F. Gaynor	John K. Esquin

twelve good and lawful jurors, were, after being duly examined under oath, accepted and sworn to try the issues joined herein. By stipulation, the Court directed the calling of one additional juror to sit with this jury, to be drawn from the same source and in the same manner and having the same qualifications as the jurors already accepted, and thereupon Ernest H. Newell, after being duly examined under [8] oath, was accepted to try the issues joined herein.

It is ordered that the further trial hereof be continued to May 18, 1944, at 10 A. M., and thereupon the jury, after being duly admonished by the Court, was excused until that time. [9]

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District Court of the United States, Northern  
District of California, Southern Division

At A Stated Term of the Southern Division of the United States District Court for the Northern District of California, held at the Court Room thereof, in the City and County of San Francisco, on Thursday the 18th day of May, in the year of

our Lord one thousand nine hundred and forty-four.

Present: The Honorable Michael J. Roche, District Judge.

[Title of Cause.]

No. 28520

MINUTES OF TRIAL. ORDER DENYING  
MOTION FOR DIRECTED VERDICT OF  
ACQUITTAL

The defendants, the attorneys, and the jury impaneled herein being present as heretofore, the further trial of this case was this day resumed. The roll of jurors was called and all answered to their names, including the alternate juror.

By stipulation, it is ordered that the alternate juror Ernest H. Newall be and he is hereby excused until notified to report.

On motion of Mr. Abrams, it is Ordered that all witnesses be excluded from the Court Room, with the exception of Agent Maguire.

Mr. Davis made an opening statement to the Court and Jury on behalf of the United States. William H. Grady, George E. Mallory, Thos. E. McGuire, James Ferguson and James A. Manning were each sworn and testified on behalf of the United States. Mr. Davis introduced in evidence and filed U. S. Exhibit No. 1. Mr. Abrams introduced in evidence [10] and filed certain exhibits which were marked Defendants' Exhibits, A, B, C, D, E. Thereupon the United States rested. Mr. Abrams made a motion for a directed verdict of

acquittal, which motion was ordered denied and to which ruling of the Court an exception was entered. George A. Weber and Margaret Brady were each sworn and testified on behalf of defendants.

After hearing the Attorneys, the Court ordered that the further trial of this case be continued to May 19, 1944 and the jury, after being duly admonished by the Court, was excused until that time.

[11]

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District Court of the United States, Northern  
District of California, Southern Division

At A Stated Term of the Southern Division of the United States District Court for the Northern District of California, held at the Court Room thereof, in the City and County of San Francisco, on Friday the 19th day of May, in the year of our Lord one thousand nine hundred and forty-four.  
Present: The Honorable Michael J. Roche, District Judge.

[Title of Cause.]

No. 28520

MINUTES OF TRIAL; DISAGREEMENT  
OF JURY

The defendants, the attorneys, and the jury impaneled herein being present as heretofore, the further trial of this case was this day resumed. Margaret Brady was recalled and gave further testimony. Irving Cowan was sworn and testified on behalf of the defendants and thereupon the defend-

ants rested. Thomas E. McGuire was recalled and gave further testimony in rebuttal. The United States then rested. After argument by the attorneys and the instructions of the Court to the Jury, the jury at 4:12 p. m. retired to deliberate upon their verdict. At 6:40 p. m. the jury returned into Court and requested certain testimony be read, also certain instructions. The requested testimony and instructions were read to the jury. At 6:56 p. m., the jury again retired to deliberate upon their verdict. At 7:40 p. m., the jury returned into Court and announced that they were unable to agree upon a verdict.

It is ordered that the jury be discharged from the [12] further consideration of this case and from attendance upon the Court until notified.

Ordered that this case be continued to June 6, 1944, for trial.

With the consent of Mr. Davis, the Court ordered that the defendants be released on the bonds heretofore given and filed. [13]

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District Court of the United States, Northern  
District of California, Southern Division

At A Stated Term of the Southern Division of the United States District Court for the Northern District of California, held at the Court Room thereof, in the City and County of San Francisco, on Tuesday the 6th day of June, in the year of our Lord one thousand nine hundred and forty-four.

Present: The Honorable Michael J. Roche, District Judge.

[Title of Cause.]

No. 28520

### MINUTES OF TRIAL

This case came on regularly this day for trial. James T. Davis, Esq., and Wilbur F. Mathewson, Esq., Assistant United States Attorneys, were present for and on behalf of the United States. The defendants Lawrence W. Brady and Margaret Brady were present with Sol A. Abrams, Esq., their attorney. Thereupon the following persons, viz:

Marjorie Boyd	Roland Mack
Robert Pfaeffle	William Dawson
John Hulten	David Lord
Edgar Reed	J. Edwin Mattox
Pauline Singleton	Leonard G. Feyen
Earl Sewall	Charles E. Ayers

twelve good and lawful jurors, were, after being duly examined under oath, accepted and sworn to try the issues joined herein. Mr. Davis and Mr. Abrams made their respective opening statements to the Court and jury. On motion of Mr. Abrams, it is ordered that all witnesses be excluded from the Court Room, with the exception of the Agent in charge of this case. [14] R. F. Love, William H. Grady and Thos. E. McGuire were each sworn and testified on behalf of the United States. Mr. Abrams introduced in evidence and filed Defendants' Exhibits A, B, C, D, E. Mr. Davis offered a certain exhibit which was marked U. S. Exhibit No. 1 for identification.

After hearing the Attorneys, it is Ordered that the further trial of this case be continued to June 7, 1944, and the jury, after being duly admonished by the Court, was excused until that time. [15]

---

District Court of the United States, Northern  
District of California, Southern Division

At A Stated Term of the Southern Division of the United States District Court for the Northern District of California, held at the Court Room thereof, in the City and County of San Francisco, on Wednesday, the 7th day of June, in the year of our Lord, one thousand nine hundred and forty-four.

Present: The Honorable Michael J. Roche, District Judge.

[Title of Cause.]

No. 28520-R

MINUTES OF TRIAL. ORDER DENYING  
MOTION FOR DIRECTED VERDICT OF  
ACQUITTAL

This case came on regularly this day for further trial. The roll of jurors was called and all answered to their names. The defendants Lawrence W. Brady and Margaret Brady, the attorneys, and the jury impaneled herein being present as heretofore, the further trial of this case was this day resumed. James Ferguson and Joseph Manning were each sworn and testified on behalf of the

United States. Mr. Davis introduced in evidence and filed U. S. Exhibit No. 1. Thereupon the United States rested. Mr. Abrams made a motion for a directed verdict of acquittal, and after hearing the arguments of the attorneys, the Court ordered that said motion be denied, and an exception noted to the ruling of the Court. Irving Cowan, Lawrence Brady, Hess Moscowitz and Margaret Brady were each sworn and testified on behalf of the defendants.

After hearing the attorneys, it is ordered that the further trial of this case be continued to June 8, 1944, and [16] the jury, after being duly admonished by the Court, was excused until that time.

[17]

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District Court of the United States, Northern  
District of California, Southern Division

At A Stated Term of the Southern Division of the United States District Court for the Northern District of California, held at the Court Room thereof, in the City and County of San Francisco, on Thursday, the 8th day of June, in the year of our Lord one thousand nine hundred and forty-four.

Present: The Honorable Michael J. Roche, District Judge.

[Title of Cause.]

No. 28520

## MINUTES OF TRIAL

This case came on regularly this day for further trial. The roll of the jurors was called and all answered to their names. The defendants Lawrence W. Brady and Margaret Brady, the attorneys, and the jury impaneled herein being present as heretofore, the further trial hereof was thereupon resumed. Margaret Brady was recalled and gave further testimony on behalf of the defendants, and said defendants rested. Dr. Francis Kearney and Ellen Jones were sworn and testified on behalf of the United States. Thomas E. McGuire was recalled and gave further testimony on behalf of the United States. Mr. Davis introduced in evidence and filed U. S. Exhibits Nos. 2, 3, 4, 5, 6, 7. Thereupon the United States rested. Margaret Brady and Lawrence W. Brady were each recalled and gave further testimony on behalf of the defendants. The defendants thereupon rested.

The Court ordered that the defendants be remanded into [18] the custody of the United States Marshal. After argument by the attorneys and the instructions of the Court to the jury, the jury at 4:19 P. M., retired to deliberate upon their verdict. At 4:41 P. M., the jury returned into Court and upon being asked if they had agreed upon a verdict, replied in the affirmative and returned the following verdict, which was ordered recorded, viz:

“We, the Jury find as to the defendants at the bar as follows:

Lawrence W. Brady Guilty on the First Count, Guilty on the Second Count.

Margaret Brady Guilty on the First Count, Guilty on the Second Count.

L. G. FEYEN,  
Foreman."

The jurors upon being asked if said verdict as recorded is their verdict, each juror replied that it was. Ordered that the jurors be discharged from the further consideration of this case and from attendance upon the Court until notified.

On motion of Mr. Abrams, the Court ordered that this case be continued to June 10, 1944, for the pronouncing of judgment.

Ordered that the defendants be remanded into the custody of the United States Marshal and that mittimus issue. [19]

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[Title of District Court and Cause.]

#### VERDICT

We, the Jury, find as to the defendants at the bar as follows:

Lawrence W. Brady Guilty on the first count. Guilty on the second count.

Margaret Brady Guilty on the first count. Guilty on the second count.

L. D. FAYEN,  
Foreman.

[Endorsed]: Filed June 8, 1944 at 4 o'clock and 41 minutes P. M. C. W. Calbreath, Clerk. By J. P. Welsh, Deputy Clerk. [20]

## District Court of the United States, Northern District of California, Southern Division

At a Stated Term of the Southern Division of the United States District Court for the Northern District of California, held at the Court Room thereof, in the City and County of San Francisco, on Saturday, the 10th day of June, in the year of our Lord one thousand nine hundred and forty-four.

Present: The Honorable Michael J. Roche, District Judge.

[Title of Cause.]

No. 28520-R.

**ORDER DENYING MOTION IN ARREST OF  
JUDGMENT AND MOTION FOR NEW  
TRIAL, AND SENTENCE**

This case came on regularly this day for the pronouncing of judgment. The defendants Lawrence W. Brady and Margaret Brady were present in the custody of the United States Marshal and with their attorney, Sol A. Abrams, Esq. James T. Davis, Esq., Assistant United States Attorney, was present on behalf of the United States. G. Albert Wahl, Probation Officer, was present.

The defendants were called for judgment. Mr. Abrams made a motion in arrest of judgment and a motion for new trial, which motion was ordered denied, and an exception entered to the ruling of the Court.

The defendants were called for judgment. After hearing the defendants and Officer Thos. E. Mc-

Guire, who was sworn and testified on behalf of the United States, the Court, upon its own motion, ordered that this case as to the defendant [27] Margaret Brady be and the same is hereby referred to the Probation Officer of this Court for pre-sentence investigation. Ordered that this case be and the same is hereby continued to June 29, 1944, for pronouncing of judgment as to said defendant Margaret Brady. Ordered that said defendant be remanded into the custody of the United States Marshal to await judgment.

Defendant Lawrence W. Brady having been now asked whether he has anything to say why judgment should not be pronounced against him, and no sufficient cause to the contrary being shown or appearing to the Court, It Is By the Court

Ordered and Adjudged that the defendant Lawrence W. Brady, having been convicted on the verdict of the jury of guilty of the offenses charged in the Indictment, be and he is hereby committed to the custody of the Attorney General or his authorized representative for imprisonment for the period of Three (3) Years and pay a fine to *to* the United States of America in the sum of One Thousand (\$1,000) Dollars on the First Count of the Indictment; be imprisoned for the period of Three (3) Years and pay a fine to the United States of America in the sum of One Thousand (\$1,000) Dollars on the Second Count of the Indictment, making a total fine in the sum of Two Thousand (\$2,000) Dollars; and that in default of payment of fine defendant be further imprisoned until said fine is paid or

defendant is otherwise discharged as provided by law.

Ordered that the term of imprisonment imposed on said defendant on the Second Count of the Indictment commence and run from and after the expiration of the term of imprisonment imposed on said defendant on the First Count of the Indictment.

Ordered that judgment be entered herein accordingly.

It Is Further Ordered that the Clerk of this Court [28] deliver a certified copy of the judgment and commitment to the United States Marshal or other qualified officer and that the same shall serve as the commitment herein.

The Court recommends commitment to a U. S. Penitentiary. [29]

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District Court of the United States, Northern District of California, Southern Division

No. 28520-R

UNITED STATES

vs.

LAWRENCE W. BRADY

JUDGMENT AND COMMITMENT

Criminal Indictment in Two Counts for Violation of Jones-Miller Act, Title 21 USC Section 174

On this 10th day of June, 1944, came the United States Attorney, and the defendant Lawrence W.

Brady appearing in proper person, and by counsel, and,

The defendant having been convicted on verdict of guilty of the offense charged in the Indictment in the above-entitled cause, to wit: Violation of Title 21 USC Section 174. Count I. Defendant did, on or about April 4, 1944, in San Francisco, California, unlawfully receive and conceal approximately one ounce and 13 grains of heroin. Count II. Defendant did, on or about April 4, 1944, in San Francisco, California, unlawfully facilitate the transportation of approximately one ounce and 13 grains of heroin, and the defendant having been now asked whether he has anything to say why judgment should not be pronounced against him, and no sufficient cause to the contrary being shown or appearing to the Court, It Is by the Court

Ordered and Adjudged that the defendant, having been found guilty of said offenses, is hereby committed to the custody of the Attorney General or his authorized representative for imprisonment for the period of Three (3) Years, and pay a fine to the United States of America in the sum of One Thousand (1,000) Dollars on the First Count of the Indictment; be imprisoned for the period of Three (3) Years, and pay a fine to the United States of America in the sum of One Thousand (1,000) Dollars on the Second Count of the Indictment, making a total fine in the sum of Two Thousand (2,000) Dollars; and that said defendant be further imprisoned until payment of said fine, or until said defendant is otherwise discharged as provided by law.

It is Further Ordered that the term of imprisonment imposed on said defendant on the Second Count of the Indictment commence and run from and after the expiration of the term of imprisonment imposed on said defendant on the First Count of the Indictment.

It Is Further Ordered that the Clerk deliver a certified copy of this judgment and commitment to the United States Marshal or other qualified officer and that the same shall serve as the commitment herein.

(Signed) MICHAEL J. ROCHE,  
United States District Judge.

Examined by:

A. J. ZIRPOLI,  
Assistant U. S. Attorney.

The Court recommends commitment to a U. S. Penitentiary.

Filed and Entered this 10th day of June, 1944.

(Signed) C. W. CALBREATH,  
Clerk.

(By) J. P. WELSH,  
Deputy Clerk.

Entered in Vol. 34 Judg. and Decrees at Page 438.

[30]

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[Title of District Court and Cause.]

**NOTICE OF APPEAL**

Name and address of Appellant: Lawrence W.

Brady, County Jail, City and County of San Francisco, State of California.

Name and address of Appellant's Attorney: Sol A. Abrams, 406 Montgomery Street, San Francisco, California.

Offense: First Count, a violation of Jones-Miller Act, 21 USC 174.

That the defendant did, on or about the 4th day of April, 1944, in the City and County of San Francisco, State of California, fraudulently and knowingly receive, conceal, and facilitate the concealment of a certain quantity of a derivative and preparation of morphine, to wit, a lot of heroin, in quantity particularly described as approximately one ounce and 13 grains of heroin, and the said heroin had been imported into the United States of America contrary to law, as said defendant then and there knew.

Second Count, a violation of Jones-Miller Act, 21 USC 174.

That the defendant did fraudulently and knowingly facilitate the transportation of a certain quantity of a derivative and preparation of morphine, to wit, a lot of heroin in quantity and [31] particularly described as approximately one ounce and 13 grains of heroin, and the said heroin had been imported into the United States of America contrary to law, as said defendant then and there knew.

Date of Judgment: June 10, 1944.

Description of Judgment and Sentence: Defendant "guilty" upon counts one and two of said indictment as above set forth.

Sentence: Defendant Lawrence W. Brady: Three years imprisonment and a fine of \$1000 on first count; three years imprisonment and a fine of \$1000 on second count, sentences to run consecutively.

Name of Prison where now confined: County Jail of the City and County of San Francisco.

I, the above named appellant, hereby appeal to the United States Circuit Court of Appeal of the Ninth Circuit, from the judgment above mentioned, on the grounds set forth below.

Dated: June 12, 1944.

LAWRENCE W. BRADY,  
Appellant.

SOL A. ABRAMS,  
Attorney for Appellant.

## GROUNDS OF APPEAL

### I.

That the learned trial judge committed errors in law arising during the course of the trial, and erred in the decision of questions of law arising during the course of the trial.

### II.

That the evidence produced and received upon the trial of said cause was insufficient as a matter of law to justify the verdict [32] of the jury.

### III.

That the learned trial judge committed error in allowing hearsay evidence upon the trial of said cause.

## IV.

That the learned trial judge erred in denying appellant's petition made in writing to quash arrests and for dismissal on all the grounds urged in said written petition which was filed on April 29, 1944.

## V.

That the learned trial judge erred in admitting in evidence during the course of the trial a package which contained the narcotics described in the indictment, which was taken by the Federal narcotic agents unlawfully and in violation of appellant's Constitutional rights under the Fourth and Fifth Amendments of the Constitution of the United States.

## VI.

That the learned trial judge erred in permitting testimony to be given during the course of the trial concerning the package containing the narcotics mentioned in the preceding paragraph, said seizure being in violation of appellant's Constitutional rights under the Fourth and Fifth Amendments of the Constitution of the United States.

## VII.

That the learned trial judge erred in overruling appellant's repeated objections made during the course of the trial to the admission of such evidence referred to in paragraph V and testimony in connection therewith.

**VIII.**

That the learned trial judge erred in denying appellant's motion made at the close of the case to strike out all testimony [33] of witnesses concerning the hospitalization of appellant in a sanatorium and his examination and treatment there.

**IX.**

That the learned trial judge erred in admitting in evidence certain records made by witness Dr. Francis Kearney entitled "Report to Division of Narcotic Enforcement" and all testimony in connection therewith, and in refusing to strike same from the record.

**X.**

That the learned trial judge erred in admitting in evidence testimony of witnesses, including Dr. Francis Kearney and Ellen Jones concerning the hospitalization of appellant in a sanatorium and his examination and treatment there, and a certain admission card of W. L. Baldwin to said sanatorium, and hospital records entitled "Doctor's Orders" in the cases of W. L. Baldwin and Mrs. Baldwin.

**XI.**

That the learned trial judge erred in denying appellant's motion, made at the close of appellee's case, for a directed verdict of acquittal on both counts of the indictment, for the reason that the legal evidence as a matter of law was insufficient to support a verdict of guilty.

**XII.**

That the learned trial judge erred in denying appellant's motion for a new trial made after the verdict and before the pronouncement of sentence, upon the grounds orally stated at the time, and supplemented by written motion filed immediately thereafter.

**XIII.**

That the learned trial judge erred in denying appellant's motion for arrest of judgment made after the verdict and before the pronouncement of sentence, upon the grounds orally stated at the time and supplemented by written motion filed immediately thereafter.

[Endorsed]: Filed June 12, 1944. [34]

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District Court of the United States, Northern District of California, Southern Division

At a Stated Term of the Southern Division of the United States District Court for the Northern District of California, held at the Court Room thereof, in the City and County of San Francisco, on Tuesday, the 13th day of June, in the year of our Lord one thousand nine hundred and forty-four.

Present: The Honorable Michael J. Roche, District Judge.

[Title of Cause.]

No. 28520-R.

**ORDER DENYING RELEASE OF DEFENDANT ON BOND PENDING APPEAL; COURT'S INSTRUCTIONS RE BILL OF EXCEPTIONS**

Now comes Sol A. Abrams, Esq., attorney for the defendant, and moves the Court to release the defendant on bond pending the appeal of the above entitled case. After hearing the argument of Mr. Abrams and Wilbur F. Mathewson, Esq., Assistant United States Attorney, It Is Ordered that said motion for the release of the defendant on bond pending the appeal be denied. By consent, It Is Ordered that the defendant have forty (40) days within which to prepare his proposed bill of exceptions; that the United States have ten (10) days thereafter for its proposed amendments; and that said bill of exceptions be settled and approved within ten (10) days thereafter. Further ordered that this case be continued to August 15, 1944, for settlement of the bill of exceptions. [35]

—  
[Title of District Court and Cause.]**ADDITIONAL GROUNDS ON NOTICE OF APPEAL**

Now comes the defendant and appellant, Lawrence W. Brady, and files these additional grounds of appeal:

**XIV.**

That the learned trial judge erred in admitting

in evidence the documentary and oral evidence mentioned in Grounds IX and X contained in the notice of appeal on file herein, which paragraphs are incorporated herein by reference, on the ground that they were privileged communications and records between doctor and client.

### XV.

That the learned trial judge erred in admitting in evidence the statements and admissions of appellant and defendant Margaret Brady on the ground that they were illegally obtained by the authorities who did not take appellant and said defendant Margaret Brady seasonably before a United States Commissioner under the rule of the McNabb case; and on the additional ground that the corpus delecti had not been proved by other testimony than the extrajudicial statements and admissions of appellant and said defendant Margaret Brady; [36] and on the additional ground that statements and admissions made after arrest by the respective defendants were not properly admissible against the other defendant, respectively, and on the additional ground that said statements and admissions were not part of the res gestae.

### XVI.

That the learned trial judge erred in denying appellant's motion made at the close of the case to strike out all testimony of witnesses concerning the hospitalization of appellant and the defendant Margaret Brady in a sanatarium and their examination and treatment there.

## XV.

That the learned trial judge erred in admitting in evidence testimony of witnesses, including Dr. Francis Kearney and Ellen Jones concerning the hospitalization of defendant Margaret Brady in a sanatorium and her examination and treatment there.

Dated: June 15, 1944.

SOL A. ABRAMS,

Attorney for Appellant.

(Acknowledgment of Receipt of Copy.)

[Endorsed]: Filed June 15, 1944. [37]

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[Title of District Court and Cause.]

### ASSIGNMENT OF ERRORS

Comes now Lawrence W. Brady, a defendant in the above entitled case, and in connection with his appeal in this case, assigns the following errors on which he relies in the prosecution of said appeal to the United States Circuit Court of Appeals:

1. That the verdict is contrary to the evidence adduced at the trial herein.
2. That the verdict is not supported by the evidence in the case.
3. That the evidence adduced at the trial is insufficient to justify said verdict.
4. That said verdict is contrary to law.
5. That the Court erred in admitting evidence in the course of the trial where no proper foundation had been laid.

6. That the Court erred in admitting evidence in the course of the trial which was hearsay.
7. That the Court erred in denying defendant's petition made in writing to quash arrest and for dismissal on all the grounds urged in said written petition which was filed on April 29, 1944. [38]
8. That the Court erred in admitting in evidence during the course of the trial a package which contained the narcotics described in the indictment, which was taken by the Federal narcotic agents unlawfully and in violation of defendant's Constitutional rights under the Fourth and Fifth Amendments of the Constitution of the United States.
9. That the Court erred in permitting testimony to be given during the course of the trial concerning the package containing the narcotics mentioned in the preceding paragraph, said seizure being in violation of defendant's Constitutional rights under the Fourth and Fifth Amendments of the Constitution of the United States.
10. That the Court erred in overruling defendant's repeated objections made during the course of the trial to the admission of such evidence referred to in paragraph 8 and testimony in connection therewith.
11. That the Court erred in denying defendant's motion made at the close of the case to strike out all testimony of witnesses concerning the hospitalization of defendants in a sanitarium and their examination and treatment there.
12. That the Court erred in admitting in evidence certain records made by the witness Dr.

Francis Kearney entitled "Report to Division of Narcotic Enforcement" and all testimony in connection therewith, and in refusing to strike the same from the record.

13. That the Court erred in admitting in evidence testimony of witnesses, including Dr. Francis Kearney and Ellen Jones concerning the hospitalization of defendants in a sanatarium and their examination and treatment there, and a certain admission card of W. L. Baldwin to said sanatarium and hospital records entitled "Doctor's Orders" in the cases of W. L. Baldwin and Mrs. Baldwin.

14. That the Court erred in denying defendant's motion made at the close of plaintiff's case, for a directed verdict of acquittal on both counts of the indictment, for the reason that the legal evidence as a matter of law was insufficient to support a verdict [39] of guilty.

15. That the Court erred in admitting in evidence statements and admissions of defendants on the ground that they were illegally obtained by the authorities who did not take defendants seasonably before a United States Commissioner, and on the additional grounds that the corpus delecti had not been proved by testimony other than the extra-judicial statements and admissions of the defendants and that said statements and admissions were not part of the res gestae.

16. That the Court erred in admitting in evidence the documentary and oral evidence mentioned in paragraphs 11, 12 and 13 herein, on the

ground that such evidence related to and directly bore upon the confidential relationship of doctor and patient and as such were privileged discussions, communications and records.

Wherefore defendant prays that the judgment and conviction herein be reversed, that his arrest and the indictment be quashed and that he be dismissed.

Dated: June 21, 1944.

SOL A. ABRAMS

Attorney for Defendant.

[Endorsed]: Filed Jun. 22, 1944. C. W. Calbreath, Clerk. [40]

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[Title of District Court and Cause.]

PRAECIPE

To the Clerk of Said Court:

Sir:

Please make transcript of appeal to consist of following:

1. Indictment.
2. Petition to quash arrests and for dismissal.
3. Order denying petition to quash arrests and for dismissal.
4. Plea of defendant.
5. Minutes of trial.
6. Verdict.
7. Motion for new trial.
8. Motion in arrest of judgment.
9. Order denying motion for new trial and motion in arrest of judgment.

10. Judgment.
11. Notice of Appeal.
12. Assignment of errors.
13. Bill of exceptions.
14. Order settling bill of exceptions.
15. This praecipe.

SOL A. ABRAMS

Attorney for Defendant

[Endorsed]: Filed Jun. 22, 1944. [41]

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[Title of District Court and Cause.]

### BILL OF EXCEPTIONS

Be it remembered, that heretofore, to wit, on the 3rd day of May, A. D. 1944, before the Honorable Michael J. Roche, the Petition to Quash Arrest, and for Dismissal came on for hearing, and that upon said hearing of said petition Mr. James T. Davis appeared as counsel for the plaintiff; and Mr. Sol A. Abrams appeared as counsel for the defendants, and the following proceedings were had:

### TESTIMONY OF WILLIAM H. GRADY

For the United States:

William H. Grady, produced as a witness on behalf of the United States, having been first duly sworn, testified substantially as follows:

I am agent of the Federal Bureau of Narcotics. I know the defendants in this case, Lawrence W. Brady and Margaret Brady. On the evening of

(Testimony of William H. Grady.)

April 4th Agent McGuire, Agent Ferguson and myself followed the two defendants in this case in their automobile into the public garage located at 840 Sutter street. I was in a Government automobile. As they drove into the garage about 70 feet their car stopped and I observed Mrs. Brady leave [42] the car and start walking toward the door of the garage. We drove in very slowly, and as she passed the car she looked directly into the car, and I was keeping her under observation, and as she got to the end of the car she dropped a package to the floor of the garage, and I walked over and picked the package up. It appeared to be narcotics to me. So the defendants were placed under arrest.

#### Cross Examination

The other officers and I were in a car that followed the car in which Mr. and Mrs. Brady were riding. Their car entered the public garage, and after being driven about 70 feet along the driveway from the front door of the garage their car came to a stop. Our car was at the curb just about *the* enter the garage when I observed the Brady car come to a stop. I observed Mrs. Brady get out of the right-hand side door of the Brady car and walk toward the front door of the garage. Our car then was driven to within ten or fifteen feet of the rear of the Brady car, and then came to a stop. As we stopped, Mrs. Brady walked past our car about four feet from the right-hand side. I was

(Testimony of William H. Grady.)

seated in the front seat on the right-hand side. I kept her under observation continuously from the time she left her car and as she passed our car I turned and continued to keep her under observation. When she was about opposite the rear wheel on the right-hand side of our car, she dropped the package, which I walked over and picked up. It was a brown envelope about two inches wide and perhaps four and a half inches long. The envelope was wrapped in white Kleenex paper. As soon as I picked the package up I said, "Just a minute, I want to talk to you about this." I called to Agent McGuire and said that I had it. I then placed Mrs. Brady under arrest. Mr. Brady did not come back with Mrs. Brady; he stayed up by his car. I believe [43] Agent McGuire placed him under arrest.

"Q. All you saw when you picked up that package was just a little package in white tissue paper, or white Kleenex, isn't that right? A. Yes.

Q. Were there any marks on it, or anything?

A. No.

Q. No writings or marks on the package, at all?

A. No.

Q. That is all you saw, just that package in that condition? A. Yes.

Q. You did not know what was inside of the package at that time, did you?

A. Not until I looked.

(Testimony of William H. Grady.)

Q. Not until you opened it up and looked inside, isn't that right? A. Yes.

The Court: Is that all from this witness?

Mr. Abrams: Yes.

Mr. Davis: Yes.

The Court: The motion will be denied.

Mr. Abrams: Exception.

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Be it further remember, that heretofore, to wit, on the 3rd day of May, A. D. 1944, before the Honorable Michael J. Roche and a jury, the above entitled cause came on for trial, and that upon said trial of said cause, Messrs. James T. Davis and Wilbur F. Mathewson appearing as counsel for the plaintiff; and Mr. Sol A. Abrams appearing as counsel for the defendants, Lawrence W. Brady and Margaret Brady, a trial was had in which the jury was unable to reach a verdict, and was subsequently discharged by the Honorable Michael J. Roche, and the case ordered retried.

Be it further remembered, that heretofore, to wit on the 6th day of June, A. D. 1944, before the Honorable Michael J. Roche and a jury, the above entitled cause came on for trial, [44] and that upon said trial of said cause, Messrs. James T. Davis and Wilbur F. Mathewson appearing as counsel for the plaintiff; and Mr. Sol A. Abrams appearing as counsel for the defendants, Lawrence W. Brady and Margaret Brady, the following proceedings were had.

## TESTIMONY OF R. F. LOVE

For the United States

R. F. Love, produced as a witness on behalf of the United States, having been first duly sworn, testified substantially as follows:

My name is R. F. Love, and I am by occupation a chemist employed by the United States Bureau of Internal Revenue, and have been so employed for the last twenty-six years.

"Mr. Davis: Mr. Clerk, may I have the heroin in this case?

Mr. Abrams: Let's leave the exhibits here and let them all be marked for identification right now and get it over with.

Mr. Davis: Very well."

Whereupon a brown paper envelope wrapped in white Kleenex paper was marked U. S. Exhibit 1 For Identification, and five photographs were marked Defendants' Exhibits A, B, C, D, and E For Identification.

On the 5th day of April, 1944 Narcotic Agent Ferguson delivered to me this brown paper envelope wrapped in white Kleenex paper, U. S. Exhibit 1 For Identification. From a chemical analysis of the contents of said envelope I have determined that the substance is heroin. The contents of U. S. Exhibit 1 For Identification have been in my custody from the time the envelope was delivered to me until the time I produced it here in court on the first trial of this case.

(No cross-examination.) [45]

## TESTIMONY OF WILLIAM H. GRADY

For the United States.

William H. Grady, produced as a witness on behalf of the United States, having been first duly sworn, testified substantially as follows:

My name is William H. Grady. I am an agent of the Federal Bureau of Narcotics. I know the two defendants in this case, Margaret and Lawrence Brady. I had known the defendants prior to the 4th day of April, and my occupation was known to them. About six o'clock in the evening on the 4th day of April, I observed the defendant Lawrence Brady drive in his Cadillac automobile into the Butterick Garage, located at 840 Sutter street, San Francisco. I was seated in a Government automobile with Agents Ferguson and McGuire. The automobile in which I was seated was parked on Sutter street near the intersection of Jones street, about half a block from the Butterick Garage. I observed the defendant Lawrence Brady leave the garage and walk across the street to the Commodore Hotel, where he disappeared from my view. In about fifteen minutes he emerged from the hotel, accompanied by his wife, Margaret Brady. They crossed the street and entered the garage. In a few moments I observed Brady drive his Cadillac car out of the garage with Mrs. Brady sitting in the front seat beside him. We in the Government car followed the Brady car to Van' Ness Avenue and Lombard street, at which point Mrs. Brady left the car and remained standing on the corner while

(Testimony of William H. Grady.)

Brady drove on out of my sight. Mrs. Brady did not meet or talk to anyone while she was standing on the corner of Van Ness Avenue and Lombard street. About five minutes later the defendant, Larry Brady, drove back in his automobile and stopped. The defendant Margaret Brady entered the automobile and the Bradys then drove back to the garage at 840 Sutter street, followed by us in our car. Their car was [46] under our observation during the entire trip from Van Ness Avenue and Lombard street to the garage at 840 Sutter street. Brady made a left-hand turn and entered the garage. We made a left-hand turn and paused at the curb line just at the entrance of the garage, facing directly into the garage, as their car stopped about 70 feet from the front entrance of the garage, and facing toward the rear of the garage. Their car was in the main runway of the garage. At that time I saw the front door on the right-hand side open and Mrs. Brady starting to get out. We then drove into the garage and our car stopped a distance of approximately ten feet behind the rear bumper of the Brady car. At the time our car stopped I got out. As I got out of our car Mrs. Brady was standing approximately abreast of the right rear wheel of the Government automobile. She had been under my observation continuously from the time she left her car and proceeded toward the entrance of the garage, until she stopped at a point opposite the right rear wheel of the Government car. When I got out of the car her back was

(Testimony of William H. Grady.)

toward me. I observed a package drop from the folds of her clothing to the cement floor in the garage. When I first observed the package it was in the process of falling.

"About what distance was it from her body in relation to the package falling?

A. Well, it was as though it had fallen directly from the folds of her coat; I would say about six inches from her body, from her legs, as it fell.

Q. Was it falling in a straight line or in an arc?

A. In a straight line.

Q. Falling down in a straight line?

A. Yes, sir."

I picked up the package. It was a brown envelope, about two inches wide and about four and a half inches long. It had two pieces of Kleenex-like material around it. U. S. Exhibit [47] 1 For Identification is the package that I am referring to. It has my initials on it. At the time I picked the package up I immediately opened it and looked at the contents.

"Q. From your experience as a narcotics officer, would you say, in your opinion, what the package contained?

Mr. Abrams: I will object to that as calling for an opinion and conclusion of the witness.

The Court: If he knows he may answer.

Mr. Abrams: Exception.

The Witness: It was my belief that it was heroin."

(Testimony of William H. Grady.)

I asked Mrs. Brady what was in the package and where she had gotten it. She denied knowing anything about where it came from, or what it was, or anything about it.

"Did you make any other remarks at that time?

A. Yes, sir. I then called out to the other agents that I, I said, 'I have it.'

Q. If you know, where were the other agents at this time?

A. I don't really know where the other agents were at this time.

Q. Did you or did you not place Mrs. Brady under arrest at that time? A. Yes, sir.

Q. Right there at the spot where you picked up the package?

A. Yes, sir, after I had looked at the contents.

Q. Did you then observe Mr. Brady in the vicinity?

A. Shortly thereafter Agents Ferguson and McGuire came over with Larry Brady to the position in which Mrs. Brady and I were standing."

There was considerable conversation between Agent McGuire and the defendant Brady, but I don't recall what that conversation was. We then took the defendants to their room in the [48] Commodore Hotel, arriving in the hotel room about 7:00 p. m. The defendant Larry Brady was searched in his hotel room but Mrs. Brady was not searched. No narcotics were found on the defendant Larry Brady or anywhere else in the room, or among the possessions of the defendants.

(Testimony of William H. Grady.)

"Q. Did you, or anyone else in your presence, have a conversation with the defendants, or either of them, in the hotel room?

A. Yes, sir. As I was searching the hotel room Agent McGuire was conversing with the defendant Larry Brady, and Brady stated—

Mr. Abrams: We will object to the conversation taking place in the hotel room as not part of the res gestae; incompetent, irrelevant, immaterial.

The Court: Overruled.

Mr. Abrams: Exception."

The defendant Lawrence Brady stated that he had purchased the narcotics for \$300 that evening and that they belonged to him. Brady stated he would like to talk to District Supervisor Manning, of the Bureau of Narcotics. Agent McGuire attempted to locate Mr. Manning by telephoning to his home. He was unsuccessful. We left the hotel room about eight o'clock and went to the District Office of the Federal Bureau of Narcotics at 68 Post street, arriving there about 8:30 or 9:00 o'clock. We then waited for the arrival of Mr. Manning.

"Q. Did you have any further conversation, or anyone else have conversations in your presence with the defendants there at the Narcotic Office before Major Manning arrived, if he did?

A. Yes, sir. . . .

Q. What were those conversations, if they pertained to this [49] case?

Mr. Abrams: I object to that as incompetent,

(Testimony of William H. Grady.)

irrelevant, and immaterial, not part of the res gestae, a violation of the constitutional rights of the defendants.

The Court: Overruled.

Mr. Abrams: Exception."

Before the arrival of Mr. Manning the conversation was of a general nature. This particular case was not discussed in my presence. Mr. Manning arrived at approximately 11:00 o'clock. He conversed with the defendants separately. He first conversed with Larry Brady in the presence of Agent McGuire and myself.

"Q. What, if anything, did Major Manning say to Mr. Brady, or did Mr. Brady say to him at that time, during that conversation?

Mr. Abrams: I object to that as incompetent, irrelevant, and immaterial, not part of the res gestae, a violation of the constitutional rights of the defendants.

The Court: Overruled.

Mr. Abrams: Exception."

At that time the defendant Brady repeated his previous statement that he had purchased the narcotics for \$300; that he had purchased them from some man in the North Beach District of San Francisco; that he was willing to make some type of a deal with the District Supervisor if neither he nor his wife were prosecuted, and with the further understanding that his car would be returned to him. I did not hear all of the conversation, as I was in and out of the office, but I heard the main

(Testimony of William H. Grady.)

part of it. He also described to Major Manning driving his car from 840 Sutter street to Van Ness and Lombard, where his wife left the automobile and he drove on. Major Manning then questioned Mrs. Brady in the presence of Agent McGuire and myself. [50]

"Q. What, if anything, did Major Manning say to Mrs. Brady or Mrs. Brady to him concerning this transaction?

Mr. Abrams: I object to that as incompetent, irrelevant, and immaterial, not part of the res gestae, a violation of the constitutional rights of the defendants.

The Court: Overruled.

Mr. Abrams: Exception."

At that time Mrs. Brady stated that the first time she had seen the package was when it was in the front seat of the Brady automobile, and that she had picked the package up, intending to take it to her hotel room. Upon picking up the package from the floor of the garage I turned it over to Agent McGuire when we reached the hotel room.

#### Cross Examination

In company with Agent McGuire I met the defendants Lawrence and Margaret Brady in the Sir Francis Drake Hotel, San Francisco, in January, 1943.

"Mr. Abrams: Q. Was it a fact at that time you had searched the room, you and Mr. McGuire had searched the room occupied by the defendants

(Testimony of William H. Grady.)

in that hotel, you had searched the room for narcotics and found no narcotics?

Mr. Davis: I object to that question as having no bearing on the issues of this case.

The Court: This was a year before?

Mr. Abrams: Yes, your Honor.

The Court: Objection sustained.

Mr. Abrams: Exception."

I had seen Brady's car in the garage at 840 Sutter street before April 4th. I believe it was a 1941 Cadillac sedan. Brady's car was seized on the evening of April 4th in the garage at the time of his arrest. As far as I know, it is still in the custody [51] of the United States Government. On the trip to Van Ness Avenue and Lombard I estimate that the car of Brady and our car were traveling at approximately twenty miles an hour, both going and coming. Mrs. Brady remained on the corner at Lombard and Van Ness Avenue for about five minutes, and her husband then returned and picked her up. It took us about seven minutes to drive from the garage to Van Ness and Lombard, and approximately the same time on the return trip. I would estimate the entire trip, including the time Mrs. Brady was standing on the corner of Lombard and Van Ness Avenue, took about nineteen or twenty minutes. I estimate we got back to the garage about fifteen minutes before seven o'clock on the evening of April 4th, and that we got to the hotel at about seven o'clock with the two defendants.

(Testimony of William H. Grady.)

"Q. When did you place the defendants under arrest?

A. I placed the defendant Mrs. Brady under arrest immediately after I had examined the package.

Q. That was after you arrived at the garage?

A. Yes, sir.

Q. In other words, you placed her under arrest just about the time you got out of the car as you arrived at the garage; is that right?

A. After I had gotten out of the car and picked up the package and examined the package.

Q. That only took a minute or so?

A. Yes, sir.

Q. Then you placed her under arrest?

A. Yes.

Q. At the same time Brady was being placed under arrest at the other end of the garage, isn't that true?

A. I don't know what was happening at the other end of the garage.

Q. As a matter of fact, it was about seven o'clock that you got to the garage, wasn't it? [52]

A. No, sir. I have testified that as far as I knew it was shortly before seven o'clock.

Q. When you say 'shortly before seven o'clock,' you mean within a minute or two of seven o'clock, don't you? A. No, sir.

Q. Not a quarter to seven?

(Testimony of William H. Grady.)

A. About quarter, that is the way I have testified, and that is the way it was.

\* \* \* \* \*

Q. Do you recall my asking you on the last trial of this case these questions and you giving these answers:

'Q. You arrested the defendants at approximately 7 p. m., isn't that right? A. Yes, sir.

Q. On this day? A. Yes, sir.

Q. April 4th? A. Yes, sir.'

Do you recall being asked those questions and giving those answers? A. Yes, sir.

Q. So that you did arrest—that is true, is it, what I have just read is correct? A. Yes, sir.

Q. Is it the truth? A. Yes, sir.

Q. You arrested the defendants when you got back to the hotel immediately on getting out of the car at about 7:00 o'clock, that would be the time when you got back to the garage, wouldn't it, and not quarter to seven?

A. The question that was asked in this was, 'It was approximately 7:00 p. m.'

Q. Do you consider approximately quarter to seven and seven o'clock the same?

A. It would depend on the circumstances."

I do not recall, and I don't think I did discuss Mr. McGuire's testimony and my own testimony since the last trial of this case. I have read a transcript of my own testimony given at [53] the last trial, but I did not read Mr. McGuire's testimony or discuss his testimony at all. I was not in the court-

(Testimony of William H. Grady.)

room during the last trial because I was an excluded witness.

"Q. Did he (McGuire) tell you there had been some questioning of him during the last trial as to how long it took to drive out to Van Ness Avenue and back, and that there were some inconsistencies between the testimony of you various agents with respect to the speed which you traveled out there, about how long it took; did you have any conversation like that with Mr. McGuire at all since the trial of this case?

Mr. Davis: I object to the question on the ground the proper foundation for impeachment has not been laid. The record has not shown in what way the testimony given at the previous trial differs from the testimony of the witness this morning.

Mr. Abrams: He said seven o'clock. He said—

The Court: Just a moment. Objection sustained. Let it go out. Let the jury disregard it for any purpose.

Mr. Abrams: Your Honor, I—

The Court: The Court has ruled.

Mr. Abrams: May I show it to your Honor?

The Court: The Court has ruled.

Mr. Abrams: Exception."

The witness testified further:

"Mr. Abrams: Q. Page 25, lines 22 and 23.

Mr. Davis: What lines, Mr. Abrams?

Mr. Abrams: Lines 22 and 23. Would you mind looking at lines 22 and 23? If you want to glance at the rest of that page it may refresh you on the

(Testimony of William H. Grady.)

whole thing, Mr. Grady. Mr. Grady, do you recall during the last trial of this case my asking you, among other questions, this question, and you [54] giving this answer:

‘Was it a clear night?

A. It was daylight yet; it was 7:00 o’clock.’

A. Yes.

Q. Do you recall that? A. Yes.

Q. Is that correct?

Mr. Davis: Just a minute. I object to this because it has not been placed—we don’t know what you are talking about.

Mr. Abrams: Well, I guess we better go back.

Mr. Davis: Go back and find out where we are.

Mr. Abrams: Q. Let’s start on line 28, page 24. Let’s start there and go where you read before.

A. Yes.

Q. Do you recall, Mr. Grady, in the last trial of this case, these questions, and you giving these answers:

‘Q. As the Brady car made the turn into the garage and proceeded in the garage, did your car follow right in behind?

A. No, sir. We stopped at the curb long enough to let it go down to where they stopped the car.

Q. You stopped at the curb line? A. Yes.

Q. How was your car facing at that moment?

A. We were approximately faced into the garage.

Q. Were you faced in toward the garage?

A. Yes.

(Testimony of William H. Grady.)

Q. In other words, you were keeping your direction, or movement, right directly into the garage?

A. Yes.

Q. The only thing is, you were paused or stopped as you reached the curb line before you entered the garage; is that it? A. Yes.

Q. You were sitting in the front seat?

A. Yes.

Q. Was it a sedan?

A. A club coupe or sedanette. It has one of these what I would term a little seat in [55] the back.

Q. One door on each side? A. Yes.

Q. A club seat in the back? A. Yes.

Q. Who was driving the car?

A. Agent McGuire.

Q. Mr. McGuire was driving the car. You were sitting in the front seat with him? A. Yes.

Q. The driver's seat was on the left and you sat on the right? A. Yes.

Q. Mr. Ferguson was in back in the club seat?

A. Yes.

Q. Were the windows of your car open?

A. I don't remember.

Q. Was it a clear night?

A. It was daylight yet, it was seven o'clock.'

Do you recall those questions and answers?

A. Yes.

Q. Those were your answers? A. Yes.

Q. They were correct? A. Yes, sir.

Q. That is the correct situation?

(Testimony of William H. Grady.)

Mr. Davis: I object to this line of questioning. There has been no proper foundation laid for impeachment, because it has not been shown in what way the witness' present testimony differs from the testimony previously given.

Mr. Abrams: The witness testified, your Honor, it was quarter to seven when he got to the garage.

Mr. Davis: He said approximately.

Mr. Abrams: He said approximately quarter to seven when he got to the garage. Now I am showing from his testimony in the previous case where they testified several times, not once, that it was seven o'clock, and a matter of fifteen minutes, your Honor, is very important in this case. Your Honor recalls in the last trial Mr. McGuire took the stand on rebuttal and got it down to twenty minutes, the trip out [56] there, in order to rebut the testimony of one of our chief witnesses in this case, by attempting to show that he had observed him every moment he was at the hotel there.

The Court: Let the question and answer stand. Proceed."

At the time I saw Mrs. Brady get out of her car our car had paused at the curb at the entrance of the garage and our car then proceeded into the garage.

"Mr. Abrams: I think we might as well put these pictures in evidence, Mr. Davis. We both agree on them.

Mr. Davis: That is agreeable.

Mr. Abrams: So the jury can look at them, and

(Testimony of William H. Grady.)

we can refer to them, if the Court please. I will offer them in evidence.

The Court: Admitted and marked.

(Photographs in and about the garage were marked Defendants' Exhibits A, B, C, D, and E in evidence.)

Mr. Abrams: May the jury see these, your Honor? May I pass these pictures to the jury for just a moment?

Mr. Davis: Just a moment, I forgot something. We will stipulate, however, these distances on the back are not to be——

Mr. Abrams: That is correct. We ask the jury not to look at the back of the pictures.

Mr. Davis: Yes.

Mr. Abrams: In other words, the jurors are not to look at the back of the pictures, just the pictures, themselves, so they will get an idea of this garage and the front entrance, and looking into it from the outside, and that is the picture from the inside of the garage."

My car was stopped and I was out of it, standing by the door on the right-hand side of the car when I saw the package drop. [57] At that time Mrs. Brady was standing opposite the right rear wheel of my car. I had been sitting in the car when Mrs. Brady passed the right front door but I had gotten out by the time I saw the package falling. I had been watching her every second of the time and, as I recall, her hands were both in front of her.

(Testimony of William H. Grady.)

She had a purse in her hands and they were joined together. I did not see the package in her hands. The first I saw of the package was as it was being dropped, and at that moment all I could see of her was her back. The package dropped down from the side of her clothing, but it fell clear of her clothing. At that moment her hands were in the same position in front of her. The position of her arms did not change. I picked the package up from a position of between four and six inches from her feet on her left side as she was facing the entrance of the garage. I am sure I was out of the car when I first saw the package. I was standing with the door open, between the fender and the door of the car. I had just left the car at the time the package was dropping.

"Mr. Abrams: This is the motion, page 6, Mr. Davis. Starting to read at line 2 and going down, say, to line 10—

Mr. Davis: What lines, Counsel?

Mr. Abrams: Lines 2 to 10.

Q. Do you remember my asking you these questions at that time, and you giving these answers:

'Q. All you could see was some white object, isn't that true, that she had dropped?

A. Well, yes, I could see the package there, and I picked it up.

Q. What was the first thing you did? You immediately got out of your car, I presume?

A. Yes.

Q. When you saw her drop the package?

(Testimony of William H. Grady.)

A. Yes.

Q. What was the first thing you did when you got out of the car?

A. Picked the package up. [58]

Q. And examined it? A. Yes.'

Do you remember being asked those questions and you giving those answers? A. Yes.

Q. Which is correct, these answers here, namely, that you were in the car and got out as soon as you saw the package drop, or your testimony that you have just given now, just previously given here, that you were out of the car and that Mrs. Brady was at the rear of the car when you saw that package drop?

Mr. Davis: Same objection, your Honor. The proper foundation is not laid, because the counsel has not yet shown in what means or what manner the testimony of the witness at this time differs from the testimony previously given. Counsel is assuming something here—

Mr. Abrams: A schoolboy could see that, your Honor.

The Court: The jury heard the testimony as you read it. Let them decide.

Mr. Abrams: I am asking the witness which is correct, were you in the car or out of the car when you saw the package drop?

A. I was out of the car, as I testified to previously.

Q. As you testified to a minute ago?

A. Yes, on several occasions.

(Testimony of William H. Grady.)

Q. But not as you testified on this occasion. As you said a moment ago, it is true that Mrs. Brady was under your observation at every moment there while you were in the garage, from the moment you saw her get out and start walking to the front, isn't that right?

A. Until the time she was under arrest, do you mean?

Q. Yes; you had her under constant observation? A. Yes, sir.

Q. You were watching her at all times?

A. Yes, sir.

Q. You didn't watch anything else around there?

[59]

Mr. Davis: I object to that, your Honor.

Mr. Abrams: I withdraw the question.

Q. Were you watching her entirely or were you also watching other things around the garage, observing other things there at the same time, or was your entire observation centered on her?

A. I don't quite understand your question, Counsel.

Q. Well, here is what I am driving at: It is true you had her under close observation at that particular time? A. Yes, sir.

Q. You were watching her constantly?

A. Yes, sir.

Q. You weren't observing anything else that was taking place in the garage, you were concentrating your observation upon Mrs. Brady; isn't that true?

(Testimony of William H. Grady.)

Mr. Davis: I object to that on the ground the question is complex and compound.

The Court: Read the question.

(Question read.)

The Court: At that particular time.

The Witness: At the time she was walking from the car to the—in making observations it is possible to see the—you see a field, you don't—it is not like you would close your eyes and you would look through the end of a funnel and just see one certain object or spot; you would see a field, as you probably well know, Counsel.

Mr. Abrams: Well, you weren't observing the floor at that time, were you, when you were observing her you weren't—

Mr. Davis: I object to this line of questioning.

The Court: Objection sustained.

Mr. Abrams: Q. You did not see anything on the floor of the garage at the time—exception to that last ruling. You did not see anything on the floor at that time, did you? [60]

Mr. Davis: I object to that as being—

Mr. Abrams: Your Honor, we have a right to see what this man saw. He says he saw a package being dropped. I am asking a very pertinent question.

Q. Were you looking at the floor? Did you see anything on the floor?

Mr. Davis: The question is too general.

The Court: When?

Mr. Abrams: At that moment.

(Testimony of William H. Grady.)

The Court: Which moment?

Mr. Abrams: That he picked up the package.

The Court: At that moment. You may answer.

Mr. Abrams: Within a few seconds.

Mr. Davis: My objection merely goes to the fact the questions are too general. The man testified he saw a package; there may have been a—

Mr. Abrams: We are not bound to accept those answers.

The Court: The Court has ruled. Read the question.

(Question read by the reporter.)

The Court: At what time?

Mr. Abrams: Q. At the time Mrs. Brady was passing your car up until the time you saw something drop on the floor.

A. The field in the area in which Mrs. Brady was walking was under my observation, as well as her person.

Q. In other words, you were observing the floor and her at the same time, is that right?

A. I couldn't hardly observe her without the floor, I would have to see a certain amount of the floor.

Q. Were you particularly looking for anything on the floor at the time?

A. Well, no, I was not particularly looking [61] for anything on the floor, but I would probably observe it if it were there.

(Testimony of William H. Grady.)

Q. On the contrary, you were watching every movement to see what she would do; isn't that true?

Mr. Davis: I object to that. It has been asked and answered. He was observing her and the floor at the same time.

The Court: There is no necessity for repeatedly going over the testimony. Now, conclude with the witness.

Mr. Abrams: May I have an answer to that question, if the Court please?

The Court: The Court has ruled. Proceed.

The witness testified further: As Mrs. Brady passed my car she looked at me, directly in the eyes. She did not make any signs or gestures of any kind, but her expression changed considerably.

“Mr. Abrams: Q. Do you remember at the last trial my asking you the following questions and you giving these answers—rather, Mr. Davis asking you the questions and you giving these answers:

‘Q. Tell me, describe exactly what you saw concerning this package you say you saw her drop. Tell us what you saw?’

A. Mrs. Brady was between me and the door of the garage. She had, as I testified, walked past me as I was getting out of the car, but I was keeping her under very close observation, and I observed the package drop to the floor, and Mrs. Brady then turned around and faced me. I walked over to recover the package.’

Do you recall that?

A. Yes, sir.

(Testimony of William H. Grady.)

Q. That was your answer?

A. Yes, sir.

Mr. Davis: If the Court please, I object to this. Ob- [62] viously, there is no proper foundation laid for impeachment here. Mr. Abrams is evidently saying she then turned around and faced him, which is an entirely different picture. We are now talking whether when she walked past the car she turned.

Mr. Abrams: That's right.

Mr. Davis: She certainly may have, and probably did, as the witness testified, turn later after she dropped the package. That is what this testimony applies to.

Mr. Abrams: It definitely says she walked past him and then turned around after he picked up the package.

The Court: All right. Where is the conflict in the testimony?

Mr. Abrams: He just testified that—I will leave it to the jury.

The Court: Well, if you leave it to the jury, let the jury decide.

Mr. Abrams: Very well, and I will argue the matter later.

The Court: Proceed.

Mr. Abrams: We will leave it to the jury. I am satisfied to leave it to the jury. I will also refer to page 34 of the transcript, lines 15—let's start in at line 7 to get the thought of it, down through line 18.

(Testimony of William H. Grady.)

The Witness: 7, did you say?

Q. Yes; 7 to 18, just to get the thought of it in there. Do you remember on the previous trial of this case I asked you these questions and you giving these answers:

Q. You got out of the car? A. Yes.

Q. You jumped out as fast as you could get out of it?

A. Well, I suppose I got out in a hurry. I don't know [63] that you would say I jumped out.

Q. You got out in a hurry and grabbed ahold of her, didn't you? A. No.

Q. You did not get out hurriedly?

A. No. Well, I mean I jumped out, but I didn't jump out and grab ahold of her.

Q. When you did jump out you did grab ahold of her? A. No.

Q. What did she do, keep on walking?

A. Yes.

Q. Did you stop her?

A. She walked a step and then dropped the package.'

Is that correct? A. Yes, sir.

Q. Do you remember giving those answers?

A. Yes, sir.

Q. To those questions? A. Yes, sir.

Mr. Davis: Well, just a minute. Your Honor, I am going to ask that that last question, the line of questioning be stricken from the record unless there is a foundation laid for impeachment.

(Testimony of William H. Grady.)

Mr. Abrams: Same thing; nothing about stopping in the meantime and turning and looking into the car in the garage.

Mr. Davis: Just a minute.

The Court: Let the record stand."

The Witness testified further: I did not know what was in the package until I looked into it. After picking up the package and examining its contents I had a short conversation with Mrs. Brady and then I made the exclamation to Agents McGuire and Ferguson that, "I have it." That was maybe one minute, two minutes, maybe three minutes after I picked the package up. I don't know where Agents McGuire and Ferguson were at that moment.

"Q. At any time in the garage, there, did Mr. Ferguson [64] say anything to you about seeing the package drop?

A. I don't recall of him having—I know he did afterward.

Q. After you left the garage? A. After.

Q. But not in the garage? A. No.

Q. Nor in the car? A. No."

The witness testified further. At the time I got out of the car and picked up the package I did not take ahold of Mrs. Brady. She did not say, 'Don't hold me so tight.' I saw the package drop from Mrs. Brady's clothing but I did not see her actually drop it."

Mr. Abrams: Page 7 of the transcript (transcript of the first trial).

(Testimony of William H. Grady.)

Mr. Davis: Which line?

Mr. Abrams: Beginning line 7 through line 11, do you remember Mr. Davis asking you at the first trial of this case these questions and you giving these answers:

"Q. In other words, she hadn't walked by the car, she had walked by your position in the car?"

A. By my position but not by the car, that's correct.

At that time we observed her drop a package to the sidewalk, or to the floor of the garage, the cement floor of the garage.'

Do you remember being asked those questions and giving those answers?

Mr. Davis: I make the same objection. There is no ground for impeachment here. There is absolutely no conflict in the testimony.

The Court: Proceed.

Mr. Abrams: All right. The jury can take that into consideration.

Mr. Davis: Well, that's all right, providing you are [65] waiving your attempt to impeach the witness.

Mr. Abrams: You will have your opportunity to argue about that.

Mr. Davis: I don't mind as long as you leave it up to them and waive your right to impeach the witness, but I don't want you attempting to impeach the witness—

The Court: Is that all from this witness?

(Testimony of William H. Grady.)

Mr. Abrams: No, your Honor. Will your Honor bear with me for a moment?"'

The witness testified further: Upon leaving the garage with Mr. and Mrs. Brady we went to their room in the Commodore Hotel. I do not recall any conversation wherein Mr. Brady asked that a charge, if any was to be placed, be placed against him and not Mrs. Brady. I do not recall any conversation about letting the car go. The first time I heard the mention of \$300 having been paid for the heroin was in the hotel room, when Mr. Brady said he had just paid \$300 for the package of narcotics. I did not hear Mr. McGuire mention that Mr. Brady must have paid \$300 for the narcotics.

"Mr. Abrams: Q. Didn't either you or Mr. McGuire tell Mr. Brady that after all, you didn't have authority to let his wife go and to prefer the charge only against him, but you would have to take it up with Mr. Manning, your chief, and that was the reason why you went down to your office and waited there until 11:30 o'clock until Mr. Manning came?

A. That is a part of the discussion at the hotel room, and that, I believe, was had in the lavatory while I was out searching the room."

The witness testified further: I did not make any notes of any conversation had with the defendants. What I have tes- [66] tified to regarding conversations is just what I recall out of my mind that I remember that I had. I do not believe the defendants were asked to make a written state-

(Testimony of William H. Grady.)

ment. On April 5th I made a fingerprint examination of the brown envelope, U. S. Exhibit 1 For Identification. I did not find the fingerprints of the defendants on the envelope. Together with the other officers, I searched the hotel room, the automobile, and the defendant Brady, and we did not find any envelopes similar to U. S. Exhibit 1 For Identification, or scales for weighing narcotics, or needles for injections.

"Q. One more question. In the garage when Mr. Brady was brought up from the rear of the garage by Mr. Ferguson and Mr. McGuire to where you were, you heard Mr. Brady also deny any knowledge of that package; isn't that true?

A. Yes, sir.

Q. He said he knew nothing about that package, never saw it before? A. Yes, sir.

Mr. Abrams: I think that is all.

Mr. Davis: That is all." [67]

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#### TESTIMONY OF THOMAS E. McGUIRE For the United States.

Thomas E. McGuire, produced as a witness on behalf of the United States, having been first duly sworn, testified substantially as follows:

My name is Thomas E. McGuire, and I am now and have been for the last sixteen years a Federal narcotics agent. I was one of the agents who

(Testimony of Thomas E. McGuire.)

worked on this case. I knew the two defendants prior to the 4th day of April 1944, and they knew me and knew what my occupation was. On April 4 I saw the defendant Mr. Brady enter the garage at 840 Sutter Street at approximately 6 or 6:15 at night. He was in a Cadillac automobile when he drove into the garage. I was parked in the Government automobile near the corner of Sutter and Jones Streets. Mr. Brady immediately left the garage and entered the Commodore Hotel across the street. About ten minutes later Mr. and Mrs. Brady emerged from the Commodore Hotel, crossed the street, and entered the garage. I then saw the Cadillac automobile, with Mr. Brady driving and Mrs. Brady seated in the front seat to his right, leave the garage and drive west on Sutter Street. We followed the Brady car to Van Ness Avenue and Lombard, where I observed Mrs. Brady leave the automobile and stand on said corner, and Mr. Brady continued driving north on Van Ness Avenue. I kept Mrs. Brady under constant observation during the time she was standing on the corner. She spoke to no one and did nothing but stand on the corner. About five minutes after having left Mrs. Brady on the corner, Mr. Brady reappeared in the same Cadillac automobile, stopped, picked up Mrs. Brady and drove to the same garage at 840 Sutter Street. I followed in the Government automobile, keeping the Brady automobile under observation during the entire trip back to the garage at 840 Sutter Street. The Brady car

(Testimony of Thomas E. McGuire.)

is a sport model Cadillac painted a two-tone color, gray and light gray. [68] I judge the entire trip from the garage to Van Ness and Lombard, and the time Brady was out of my sight, and the trip back to the garage consumed about twenty minutes. It was about 10 minutes to 7 or quarter to 7 when we returned to the garage at 840 Sutter Street.

I was driving the Government car, and when Brady made a left-hand turn from Sutter Street into the garage I was not more than a quarter of a block behind his car. I slowed down at the time and allowed him to continue on into the garage before we turned. We made a left-hand turn from Sutter Street into the garage at almost the same time that they were inside the building line, so the car was practically observed all the way into the garage while it was moving. Brady's car moved approximately 70 or 75 feet inside the garage while we made the left-hand turn to continue into the garage. While Brady's car made 70 feet inside the building line we made approximately 25 or 30 feet from the right-hand side of Sutter Street to the building line of the garage. We were moving into the garage when their car was stopped. The first thing I saw after the Brady car stopped was Mrs. Brady leaving the right-hand side of the Brady car. Brady had been driving the car and she had been next to him in the front seat. While Mrs. Brady left her car and began to walk in the direction that we were, I should judge we moved maybe 10, 12 or 15 feet behind Brady's car and stopped.

(Testimony of Thomas E. McGuire.)

Mrs. Brady walked in a straight line from her car to our car on the right-hand side of both cars. I saw Mr. Brady leave his car a moment or two after Mrs. Brady had been seen to leave the car, and he walked to the front of his car, to the hood of his automobile. I left my car and immediately went to where Mr. Brady was standing. Mrs. Brady was just opposite the front seat of my automobile at the time I left the car. I did not see Mrs. Brady as she [69] walked toward the back of my car. I had just about reached Mr. Brady when I heard Mr. Grady, the narcotics agent, remark, "I have it." After hearing that remark I then went to Brady and told him that he was under arrest. I believe Mr. Ferguson joined me within a moment or so. I believe I was there first. Mr. Brady wanted to know what reason I had for placing him under arrest. He made one or two remarks and a threatening gesture or two, so I had the handcuffs placed on him by Mr. Ferguson. I told him then he had to behave himself and do as I told him. We then walked back to where Mr. Grady, the narcotics agent, was standing with Mrs. Brady. I then took the narcotics that Mr. Grady, the narcotics agent, had in his hand. I asked Mrs. Brady if she had seen the narcotics, and she denied that she had seen them or that she knew anything about them. I stated then in her presence that Mr. Grady, the narcotics agent, whom she knew, had stated that he had seen her drop them. She stated

(Testimony of Thomas E. McGuire.)

she did not drop them. I told the defendant Lawrence Brady at that time that he was under arrest for transporting narcotics, as Mr. Grady, the narcotics agent, had seen Mrs. Brady drop the narcotics. Within a very short while after this we went to the Bradys' room in the Hotel Commodore, across the street from the garage. Mr. Grady and Mr. Ferguson searched the room. I helped search Brady. I took his wallet out of his pocket. It contained a number of race horse tickets and some \$1700 in cash, and his draft card, some seaman's papers. I did not find any narcotics on his person or among his possessions. We had arrived at the hotel room at approximately 7 o'clock or 5 minutes after 7. The arrest took place, I should judge, at 10 minutes to 7.

"Q. Did you have any conversation, or did anyone else in your presence, with either Mr. or Mrs. Brady, relative to this transaction while in the hotel room? [70]

A. Yes. I stated at that time—

Mr. Abrams: Let me make my objection, please. I object to this as incompetent, irrelevant, and immaterial, not part of the res gestae, a violation of the constitutional rights of the defendant.

The Court: Overruled.

Mr. Abrams: Exception."

The witness testified further: While Mr. Ferguson and Mr. Grady were searching the entire room, I had a conversation with the defendants. I told them

(Testimony of Thomas E. McGuire.)

they were under arrest for transportation of the narcotics which I showed them again. Brady then asked that the handcuffs be removed, which was done. I asked him where the narcotics had come from. He said he paid \$300 for it and that he was getting "sick and tired of being taken." Those were the words he used. He said, "This stuff isn't worth \$50 an ounce, and they are holding me up and robbing me of all the money I can put my hands on. What can I get out of the deal if I give you the man's name? What can I do to help myself in this proposition?" I then told Mr. Brady that my district supervisor, Mr. Manning, was the only man who had that responsibility and that I could not give him any understanding or any chance to be released, or any help or any consideration whatsoever; that the only thing I could do was let him talk to my district supervisor, Mr. Manning. He then asked to be taken to the district supervisor, Mr. Manning, so that he could talk directly with Mr. Manning. I attempted to communicate with Mr. Manning by telephone from the hotel room, but was unable to do so at that particular time. We then left the hotel room, Mr. and Mrs. Brady, agent Ferguson and Grady and myself, and went to the Bureau of Narcotics office at 68 Post Street. At about 11:15 or 11:30 Mr. Manning reached the office.

"Q. When Mr. Manning reached there did he have a [71] conversation in your presence with the defendants, or either of them?

(Testimony of Thomas E. McGuire.)

A. Yes, sir.

Q. Did he have them with them together, or were his conversations had with the defendants separately?

A. They were separate.

Q. Which defendant did Mr. Manning speak to first? A. Brady, himself.

Q. Were you present during that conversation?

A. Yes, I was present throughout most of the conversation.

Q. What did Mr. Brady say to Mr. Manning, or Mr. Manning to Mr. Brady, concerning the transaction under question?

Mr. Abrams: I will object to that on the ground it is incompetent, irrelevant, and immaterial, not part of the res gestae, and a violation of the constitutional rights of the defendants.

The Court: Overruled.

Mr. Abrams: Exception.

The Witness: A. At first I gave a detailed report to my immediate superior, District Supervisor Manning, of what had transpired, the extent of the evidence against both defendants produced in the office. After that I stated, I made known to the District Supervisor the message in which Brady had asked me to intercede in his behalf and help him to get some consideration. So with that in mind I called Brady into the District Supervisor's private office. I remained there for some time. The defendant Brady stated to the District Supervisor that he had been addicted to the use of narcotics

(Testimony of Thomas E. McGuire.)

for a period of some two or three years, that he had spent a fortune maintaining his addiction, that he could not carry on and do that, that the heroin had been so badly adulterated that he could not maintain his habit [72] without spending a quite considerable amount of money, he had done so for the past year and a half, and he understood now that the people that he was doing business with were taking him, and practically robbing him of every cent that he had, and under the circumstances he offered to turn over to the boss, to the District Supervisor, all the information that he had, and, furthermore, agreed to tell the District Supervisor the names of several people here whom he was positive that the boss, the District Supervisor did not know were in the narcotic traffic.

Mr. Davis: Q. At that time did Mr. Manning, in your presence, show the defendant this heroin that is marked here for the purpose of identification and have any discussion concerning that?

A. Yes, he did; he showed it to him. He said, 'Larry, how much did you pay for this?' Larry stated he had paid \$300 for it. So the District Supervisor asked him, 'Where did you get it?' So he said, 'Well, I didn't want to get the old lady mixed up in the deal, and' he said, 'I drove to the corner, I left her standing at Lombard and Van Ness Avenue so she wouldn't get mixed into the deal.' He said, 'Why, do I have to tell you the names before you make any agreement with me?' So the District Supervisor said, 'Well, how can

(Testimony of Thomas E. McGuire.)

you tell me the names of others; what is the deal that you want to make?' The defendant stated that to give this information and to turn up these people, to secure the evidence against these people, he would have to be released and have his car returned to him because it had been explained to him that the car had been seized and he could no longer have the car in his name as the Government was seizing it, and that his wife would be arrested. He then [73] asked that his proposition would be that he would have to be released without going to jail, his wife would be released and his car be returned to him. The District Supervisor, of course, told him that that would be impossible and that could not be entered into by anybody, much less the District Supervisor.

Q. Did the District Supervisor, in your presence, have any conversation with Mrs. Brady?

A. He did.

Q. Was that out of the presence of Mr. Brady?

A. She was brought in after Mr. Brady had been let out of the office.

Q. What at that time did Mr. Manning say to Mrs. Brady and what did she say to Mr. Manning?

A. Well, I had previously had the same conversation covering the background of Mrs. Brady with Mr. Manning, the District Supervisor, and the information which Mr. Manning had in the file, and I more or less gave a brief outline to him concerning Mrs. Brady.

(Testimony of Thomas E. McGuire.)

Mr. Abrams: Are you going on with Mrs. Brady's conversation? If you are, I want to make the same objection.

Mr. Davis: Yes.

Mr. Abrams: I make the same objection I made before, it is incompetent, irrelevant, and immaterial, not part of the res gestae, a violation of the constitutional rights of the defendant.

The Court: The objection will be overruled.

Mr. Abrams: Exception.

The Witness: A. Mrs. Brady at that time—I stated to Mr. Manning in Mrs. Brady's presence that the arrangements to purchase the narcotics had been made in the hotel room in the afternoon and in Mrs. Brady's presence I explained that [74] there had been a man enter the hotel whom we very highly suspected as being a dealer in narcotics. Mrs. Brady said that he did not go to her room. However, I accused Mrs. Brady of being the one who made the arrangement for this meeting for Mr. Brady with the person from whom he purchased the narcotics. Mrs. Brady denied that, saying that she hadn't talked to anyone in the afternoon, but that she came out with her husband and got into the car and drove down there and got out and he left, and when he came back the narcotics was sitting between her and her husband in the car, and she had picked it up and held it in her hand, intending to take it back to the room, but when she saw the agents she let it go, she didn't hold it any longer.

(Testimony of Thomas E. McGuire.)

Mr. Davis: Q. As far as you recall, that was the gist of the conversation held at the narcotics office at 68 Post Street?

A. There was other conversation there, but at the moment I can't recall exactly. We must have talked at least a half hour, three-quarters of an hour, if not longer, among one another, while the District Supervisor was there, but for the two or three hours before that, waiting for the District Supervisor, we had quite a lengthy conversation with both defendants relative to the narcotic traffic here in San Francisco.

Q. What did you do after these conversations were completed at the narcotics office, what was the next thing you did, as far as the narcotics were concerned?

A. Both defendants were then placed in the City Jail for arraignment before the United States Commissioner, the following day, for narcotics.

Q. I will show you this envelope wrapped in Kleenex, and ask if you have ever seen it before.

[75]

A. This is the envelope of narcotics which Agent Grady gave to me. My initials are on it, 'T. E. McG.' This is the envelope which I showed Mr. Brady and Mrs. Brady at the time of their arrest.

Q. It was wrapped in this Kleenex.

A. Tissue paper, yes.

Q. After you received this package from Mr.

(Testimony of Thomas E. McGuire.)

Grady to whom, if to anyone, did you give the package?

A. I retained it in my custody until the following day, at which time I turned it over to Agent Ferguson, who in turn forwarded it to the United States Chemist."

#### Cross-Examination

"Q. As a matter of fact, about January of the year before, 1943, you had occasion to meet Mr. and Mrs. Brady at the Sir Francis Drake Hotel, where they were staying, and searched their apartment, did you not?

Mr. Davis: I object to that on the ground it is incompetent, irrelevant, and immaterial, and has no bearing on the issues of this case, and being too remote.

The Court: What is the purpose of the testimony?

Mr. Abrams: To show this jury Mr. McGuire knew the Bradys and had endeavored to locate narcotics there at that time but was unsuccessful, two years before.

The Court: Objection sustained.

Mr. Abrams: Exception.

Q. That is the first time you met Mr. or Mrs. Brady, January of 1943, approximately, at the Sir Francis Drake Hotel?

Mr. Davis: I make the same objection, your Honor. The Court has already ruled on this line of questions.

(Testimony of Thomas E. McGuire.)

The Court: Well, for the purpose of identifying them and being acquainted I will allow it.

The Witness: A. In a sense of the word, I was [76] acquainted with them before that. The first time I had spoken to them was about that date that you say. I had a report on them, yes.

Mr. Abrams: Q. That was the first time you talked to them?

A. That was the first time I talked to them, yes."

The witness testified further: When we returned from Van Ness Avenue and Lombard Street to the garage, I would say that our car had stopped at the time Mr. Grady got out. I believe Mr. Ferguson got out of the car almost at the same time agent Grady did. We all three got out as quickly as we could.

"Q. Did you have any prearrangement about getting out of the car? A. No.

Q. You just happened to get out?

A. Yes, sir.

Q. When your car had come to a stop you just all got out, there was no prearrangement about it?

A. No, there wasn't any.

Q. Page 61 of the transcript. Would you read that, Mr. McGuire?

Mr. Davis: Lines?

Mr. Abrams: Line 18 to the end. (Hands transcript to witness). Do you remember at the last trial of this case being asked this question and you giving this answer:

(Testimony of Thomas E. McGuire.)

'Q. What was the next thing that you observed, if anything?

A. Well, I immediately, of course, when Agents Grady and Ferguson, by prearrangement they got out on their side of the car. I immediately got out on my side of the car and went directly to where Mr. Brady was.'

Do you remember that question and that answer?

A. I see by the record that it was asked. I don't recall that question, but it evidently was asked.

Q. Do you recall giving that answer? [77]

A. I cannot recall giving that answer.

Q. Well, what do you think? You might have acted by prearrangement there?

A. Well, it is not clear, counselor, as far as I can see, whether by prearrangement that they were getting out of the car, or prearrangement that they were going to be arrested or prearrangement that we were going to pick them up.

Q. That is what you meant by the word 'pre-arrangement' there?

A. No, I wouldn't say I did, not in the sense it is used there.

Q. There was no prearrangement, then, for Grady and Ferguson to get out and for you to get out and act in any certain way?

A. We had not arranged how they were to get out or when they were to get out, or how they were to go about that.

(Testimony of Thomas E. McGuire.)

Q. Was there any prearrangement that Mr. Grady was to jump out and grab ahold of Mrs. Brady, and you and Ferguson would go forward and grab ahold of Mr. Brady, wasn't that what you meant by prearrangement?

A. No. I don't know just how that word was used there, I mean in the sense of prearrangement how we were to get out of the car."

The witness testified further: When I got out of the car I immediately went to the front of Brady's car where Brady was.

"Q. What was Brady doing at the time?

A. He was just standing there when he saw me walking up to him.

Q. Was he doing anything in connection with his car?

A. I did not observe anything.

Q. Page 62, immediately after what I just read a moment ago, just the first paragraph of page 62. Do you remember these questions and answers:

[78]

'Q. Mr. Brady? A. Mr. Brady.

Q. Where was he at that time?

A. The defendant, Mr. Brady, was standing in the front of his car just getting ready to open the hood of his automobile.'

Do you remember that question and answer?

A. I see by the record that it was asked. I don't recall—it says there that was exactly what was said.

(Testimony of Thomas E. McGuire.)

Q. Do you recall now that Mr. Brady was tinkering with the hood of his car at the time you approached him?

A. No. I recall later, because I read that transcript, that further on I stated that he told me he was going to open the hood of his car.

Q. You actually saw him tinkering with the front of his car, didn't you?

A. When I walked up to him I don't think he was doing anything. He might have been. I won't deny that.

Q. What do you mean, 'just getting ready to open the hood'?

A. He was standing right there in a position where he might have opened it if he continued on with his actions, but when he saw he was frozen.

\* \* \* \* \*

Mr. Abrams: Q. You say he was just getting ready to open the hood?

A. That is my impression, my opinion.

Q. From what you saw?

A. That is, I had an opinion that he might have been doing that.

Q. You did not say he might have been. You say he was in front of his car, just getting ready to open the hood on his car, and you made that statement because of what you observed there?

A. No. I observed him at the front of the car, he might have been ready to open it— [79]

Q. Well, we will find it at another place, here. We have it at another place. Page 71. Maybe this

(Testimony of Thomas E. McGuire.)

will hit it here. Read this down here on page 71 and over onto 72, start at line 29, just a couple of lines down there.

A. Wait a minute. There is something here.

Q. I am not trying to catch you.

A. Yes, that is the substance.

Q. Do you remember my asking you on cross-examination in the last trial of this case, asking you these questions and you giving these answers:

'Q. You got out of the car and you went up to where he was standing in front of his car. He was tusseling around with the radiator, wasn't he?

A. The impression I received was that he was going to open the hood, because he was standing right there, and then he told me that he was when we were talking about it in the office.'

Do you remember that question and you giving that answer? A. Yes.

Q. Did you hear Mr. Grady exclaim, 'I have it,' or something to that effect?

A. Yes; to the best of my knowledge he said, 'I have it,' or 'I found it.'

Q. Where were you when you heard that?

A. Just about at Brady's side.

Q. Had you just gotten there?

A. Just about. I would judge—it happened so quickly, I would say just about that time.

Q. Just about as you got to him?

A. It might have been while I was walking up to him, it was in a very close time.

Mr. Davis: Just a minute. [80]

(Testimony of Thomas E. McGuire.)

Mr. Abrams: Are you satisfied with that answer?

Mr. Davis: I believe you said just as it appeared he got there. You are talking about someone calling out?

Mr. Abrams: I may have. You heard that shout just as you were getting to Brady?

A. Just as I was getting to him; I was only 15 or 20 feet away from him at any time, so when I heard it I couldn't say right now, counselor.

Q. You practically got to Brady's side just seconds after, almost instantaneously with Grady getting out of the car?

A. It all happened very quickly, yes.

Q. It wasn't, then, four or five minutes after Grady had gotten out of the car that you heard the shout, or exclamation, 'I have it', was it?

A. My impression is it was very quickly; it was not four or five minutes' time, although I won't be sure of the amount of time consumed, but it seems to me it was almost at the same time."

The witness testified further: When Mrs. Brady had left the Brady car and was approaching our car, I observed her carrying a large purse out in front of her. I did not see any little white package in her hand or arms. I did not see her drop a package. After the arrests, I recall Mr. Ferguson saying that he had seen the package drop. He said that while we were all standing together at the place where Mrs. Brady and Mr. Grady had been standing and I was giving directions.

(Testimony of Thomas E. McGuire.)

“Q. Do you recollect being asked these questions and giving these answers on the prior trial of this case:

‘Q. He was sitting in the back?

A. Ferguson was in the back seat.

Q. Did he make any statement as you drove in and [81] observed Mrs. Brady? A. Yes.

Q. What did he say?

Q. Do you want me to tell you what Ferguson told me? He told me that she dropped it, he saw it.

Q. Ferguson said he saw her drop it?

A. Yes, he told me in the car.

Q. He told you he saw her—

A. I won’t say he told me in the car, it happened so quickly, but he had seen it.

Q. While he was in the car?

A. I won’t say whether it was in the car.’

Do you remember those questions and answers?

A. Only from refreshing my memory on it, I remember that now.

Mr. Davis: I object, your Honor, to this line of questioning on the ground that there has been no conflict shown between this testimony and what the witness testified to now.

The Court: The jury heard the testimony.

Mr. Abrams: You bet they did.

Q. I will ask you again, where was it that Ferguson told you—where were you when Ferguson told you that he saw a package drop; was it in the car, as you testified here? A. No.

(Testimony of Thomas E. McGuire.)

Q. Or—wait a minute—or was it out of the car, or was it at a time when you were in that car, or just getting out of the car, or was it after when you were all together, as you just testified?

Mr. Davis: I object to that for the same reason. Counsel, I believe, is misstating the record. The witness on the first trial said, ‘I won’t say he told me in the car, it happened so quickly, but he had seen it.’

Mr. Abrams: Read the first part. He said in the car. He is testifying, if the Court please—I just want to ask [82] the witness now, I think I have a right to. Where were you when Ferguson told you that?

A. I couldn’t say where I was. All I can definitely say—

Q. Were you in the car?

The Court: Just a minute. Let him conclude the answer.

A. All I can definitely say is that Ferguson stated that he had seen it drop. I cannot say whether it was in the car, while we were all standing together, or while we were standing at the front of Brady’s automobile at that time, although I definitely heard Ferguson say that he had seen her drop it.

Mr. Abrams: Q. You say here, ‘Yes, he told me in the car.’

A. And then I qualified it later on, four sentences down, I said, ‘I won’t say whether it was in the car.’

(Testimony of Thomas E. McGuire.)

Q. But a few minutes ago you said it was when you were all together.

A. I said it could be when we were all together, it could be at the front of the car or could be in the car; I won't say definitely when I heard the remark, it happened so quickly.

Q. You heard Mr. Ferguson testify in this case after you testified at the last trial, didn't you?

A. I was in the court-room when he testified, yes.

Q. You recall, Mr. McGuire, don't you, very clearly, that when Mr. Ferguson testified on the previous trial after you had finished your testimony in the first trial, you recall sitting there with Mr. Davis and you recall hearing Mr. Ferguson——

Mr. Davis: If the Court please, I object to that question as to what Mr. Ferguson said. Mr. Ferguson is not on the witness stand.

Mr. Abrams: I am asking him whether he heard it. This [83] is proper impeachment, because he is testifying differently now than he did at the last trial, and that he heard Mr. Ferguson.

The Court: Just a moment. Let the jury disregard that statement for any purpose in this case. It has no place in the record, at all. Let's proceed in an orderly manner.

Mr. Abrams: Let me ask you this: Do you recall the last trial of this case? A. Yes.

Q. You were the second witness to testify?

A. I couldn't answer that. I was one of the witnesses.

(Testimony of Thomas E. McGuire.)

Q. You were here—

A. Yes; I don't know whether I was the second or fourth. I believe the chemist was the second witness and then I went on, if you want to be exact, but I did testify.

Q. You were designated by the Government as the witness to stay here and direct the course of the trial during the whole course of the trial?

A. I was retained by the United States Attorney.

Q. And sat there during the whole course of the trial as the agent designated to help Mr. Davis and assist him in the trial of the case?

Mr. Davis: I object to that as incompetent, irrelevant, and immaterial.

The Witness: A. Yes.

Mr. Abrams: Q. You were here when every witness testified? A. Yes.

Q. You heard every witness testify?

A. Yes.

Q. But every witness did not hear you testify, did they?

A. I cannot answer that, but I would say no. The rule was on.

Q. Mr. Ferguson went on and was not permitted to be in the [84] court-room while others were testifying; is that true? A. Yes.

Q. You heard his testimony but he did not hear your testimony; is that correct?

Mr. Davis: I object to that as being incompetent, irrelevant, and immaterial.

(Testimony of Thomas E. McGuire.)

Mr. Abrams: I am coming to it, your Honor; I am coming to it right now.

Q. Can't you answer that without looking at his Honor?

The Witness: Well, an objection was made. I didn't hear it ruled on. I will answer it if you wish. I sat here while the other witnesses testified. I heard Mr. Ferguson testify.

Q. But he did not hear you testify?

A. No.

Q. Did you hear Mr. Ferguson testify in response to my question when I asked him where he was when he mentioned to you, or to the other agent, where he was when he mentioned that he had seen a package drop? You heard him testify, did you not, that it was up in front of the garage when you and he had taken Brady up there and to where Grady and Mrs. Brady were, that was when he mentioned that he saw a package dropping; do you remember hearing that at the last trial of this case?

Mr. Davis: I object to that as incompetent, irrelevant, and immaterial, what Mr. McGuire heard Mr. Ferguson testify to, whether he heard him or did not hear him.

Mr. Abrams: I asked him if he heard Mr. Ferguson testify to that fact, and the jury has a right to come to some conclusion, or draw some inference as to the reason for his testimony in this case. It all goes to the weight of the testimony. [85]

(Testimony of Thomas E. McGuire.)

Mr. Davis: You can ask Mr. Ferguson when he testifies.

Mr. Abrams: He is the one who is testifying.

The Court: Read the question.

(Question read by the reporter.)

The Court: You may answer.

The Witness: A. I can't remember that exact question."

The witness testified further: When I went to where Brady was standing at the front of his car in the garage, I frisked Brady for a gun and ordered the handcuffs put on him. That was after I had heard Grady shout, "I have it."

"Mr. Abrams: Q. You frisked him and then you put the handcuffs on; is that right?

A. I won't say that, Counselor. I will say—I will qualify that by saying that immediately I went to him I began to frisk him. I don't remember if it was the result of frisking him that he made the threatening gesture and I ordered the handcuffs put on, or that when I went to him he made a threatening gesture and I ordered the handcuffs put on him; it took longer to put the handcuffs on him than to frisk him.

Q. You don't change your answer simply because I—

The Court: Just a moment. You proceed. You know better than anyone who comes in here you cannot proceed that way. You use argument in your questions and you are arguing with the wit-

(Testimony of Thomas E. McGuire.)

ness, something that has no place here. Proceed in the usual way.

Mr. Abrams: I am asking him if he changes his testimony here because——

The Court: The jury heard the testimony. They will determine what the witness has said.

Mr. Abrams: Q. In other words, you are not sure which [86] took place first, the handcuffing or the frisking?

A. I won't say positively, no, not to the extent of swearing which actually took place. I say both took place, but in orderly procedure of that, I won't swear to it.

Q. You would not frisk a man with a gun after you put the handcuffs on him, however; that is not the usual procedure?

Mr. Davis: I object to that.

The Court: Objection sustained.

Mr. Abrams: Q. I mean there wouldn't be a necessity for frisking him for a gun if has the handcuffs on?

Mr. Davis: Same objection.

The Court: Objection sustained.

Mr. Abrams: Q. Is that the usual procedure?

Mr. Davis: Same objection.

The Court: Objection sustained.

Mr. Abrams: Exceptions for all those, your Honor.

Q. As a matter of fact, you searched him for narcotics, didn't you?

A. I did not make any search for narcotics, no.

(Testimony of Thomas E. McGuire.)

Q. Isn't that the custom?

Mr. Davis: I object to that.

The Court: Objection sustained.

Mr. Abrams: Q. Don't you always search a man for narcotics when you arrest him?

Mr. Davis: Same objection.

The Court: Sustained as to what he always does.

Mr. Abrams: Exception. Aren't we permitted, your Honor—

The Court: What was done in this case?

Mr. Abrams: Q. You did search this man after you arrested him and placed the handcuffs on him, you did search him to see if he had narcotics in his possession? [87]

A. I did not search that man for narcotics, no.

Q. You searched him only to see if he had a gun? A. That's right.

Q. Did you find a knife in his pocket?

A. That's right.

Q. What kind of a search did you make?

A. I felt of his body, where the gun is usually kept by men, in the belt, his hip pocket. I felt the inside coat pocket. I felt the knife and I removed the knife.

Q. Did you go into his pocket?

A. I took the knife out when I felt it from the outside. I struck the sides of his coat and I felt the knife and removed it.

Q. You went into his pockets, didn't you?

A. The one pocket, yes.

Q. Page 73, beginning with line 20, down

(Testimony of Thomas E. McGuire.)

through line 1 on the next page, 74 (handing transcript to witness.)

A. Yes, that is substantially what I said.

Q. You remember all that?

A. Yes, I mean I remember about that taking place.

Q. Do you remember being asked these questions and giving these answers on the last trial of this case:

'Q. Who put the handcuffs on Brady?

A. Mr. Ferguson.

Q. Ferguson was putting the handcuffs on him while you were searching him?

A. I wouldn't say that. When I first went to search the man—when I stood there and I went to searching him I removed a knife from his pocket at that time, and at that very moment he drew back and in a threatening—what I thought was a threatening manner, I then ordered the handcuffs placed on him by Mr. Ferguson. Mr. [88] Ferguson had the handcuffs, and the handcuffs were placed on him then. Then I continued the search, just a quick search over his body to make sure the gun was not there. Then I brought him to where his wife was standing with Mr. Grady, the narcotics agent.'

Do you remember those questions and answers?

A. Yes.

Mr. Davis: I object to this line of questioning, your Honor, on the ground that there is no showing that there is any conflict between the testimony,

(Testimony of Thomas E. McGuire.)

no foundation for impeachment here. Mr. Abrams is putting his own interpretation on certain words.

The Court: Well, if there is a conflict the jury heard the testimony.

Mr. Davis: As long as it is understood the witness has not been impeached.

Mr. Abrams: Q. You also took money and some mutual tickets out of his pocket at the time you searched him?

A. That was up in his room and at that time I counted out \$1700, and it involved quite considerable counting.

Q. When you searched him down there you found that money and those tickets in his pocket?

A. No, I don't think I did. That money was found in the room and counted in the room. I laid the money down on the bed while I was counting it. It was in hundred-dollar bills, and about \$1300 in racehorse tickets was counted out, by the way.

Q. Mrs. Brady and Mr. Brady, in the garage, both told you that they didn't know anything about that package?

A. They both stated that in the garage when they were first arrested.

Q. That was the first statement you had from them in the [89] garage, there?

A. That was the first statement, that they denied owning it."

The witness testified further: In my conversations with Mr. Brady I did not suggest to him that he had paid \$300 for the heroin, U. S. Exhibit No. 1

(Testimony of Thomas E. McGuire.)

for Identification. He informed me that it cost him that much. He asked me for consideration, to be allowed to turn up the people with whom he was dealing in narcotics; in other words, his source of supply, some of whom he stated were the biggest shots in town. Later in the conversation with Mr. Manning he made the same statements, but asked that in return for supplying this information to us that he and his wife not be arrested, that no charge be placed against them, and that his car be released. Mr. Manning refused to agree to such a proposition as made by the defendant Brady. I made no written memorandum of my conversations with the defendants. They were not asked to sign any written statements. I know a man by the name of Irving Cowan.

"Mr. Abrams: Q. You arrested him, did you not, on an alleged narcotic transaction just a short time before the Bradys were arrested?

Mr. Davis: I object to that as improper cross-examination.

The Court: I will sustain the objection at this time.

Mr. Abrams: Exception.

Q. Did you have any conversation at or about that time, just prior to the arrest of the Bradys, with Cowan, relative to the Bradys?

Mr. Davis: I object to that as improper cross-examination.

Mr. Abrams: I want to show bias, prejudice and motive. [90]

(Testimony of Thomas E. McGuire.)

Mr. Davis: There is nothing in the record, here, of anybody by the name of Cowan.

The Court: I will sustain the objection at this time.

Mr. Abrams: Exception.

Q. Did you ever tell Cowan——

Mr. Davis: I will object, your Honor, to anything that this witness may know about Cowan, anything he may have told Cowan is incompetent, irrelevant, and immaterial, and has no bearing on the issues of this case, and it is improper cross-examination.

Mr. Abrams: May I ask one or two preliminary questions before your Honor rules, to give an idea of what I am driving at?

Mr. Davis: The Court has already ruled on all the questions you asked, outside of the first one, if the witness knew Cowan.

The Court: I cannot anticipate what this trial may develop. At this time I will sustain the objection to those questions.

Mr. Abrams: Q. Did you have any conversation with Mr. Cowan in which you—prior to the arrest, just prior to you arresting Mr. and Mrs. Brady, in which you told him that you were not particularly interested in Cowan, but you would like to have him—but you were interested in getting the Bradys and that you would like to have Cowan help him along that line, and that Cowan would get some consideration from you if he played along?

Mr. Davis: Same objection.

(Testimony of Thomas E. McGuire.)

The Court: I will allow the witness to answer.

The Witness: A. No, I did not have any conversation with Cowan relative to testifying against Mr. Brady. [91]

Mr. Abrams: Q. Did you have any conversation with Cowan about giving you an affidavit or appearing before the Federal grand jury against Brady?

Mr. Davis: I make the same objection. We are just going far afield here. We might as well be talking about Smith.

The Court: Objection sustained.

Mr. Abrams: Exception.

Q. Mr. Brady came over to Mr. Cowan's room at your request at the time you arrested Mr. Cowan, did he not, just prior to Mr. Brady's arrest?

Mr. Davis: To which I make the same objection.

The Court: At the time of the arrest?

Mr. Abrams: Q. Mr. Brady came over to Mr. Cowan's room at your request at the time that Mr. Cowan was arrested just shortly before the Bradys' arrest?

Mr. Davis: Same objection, your Honor. It is with reference to some arrest that took place long before the transaction involved here.

The Court: Sustained.

Mr. Abrams: Exception.

Q. Didn't you arrest Mr. Cowan and at that time find some narcotics in his possession, heroin, the same as this heroin identified in this case, and ask Cowan to say that he had got that stuff for Larry Brady?

(Testimony of Thomas E. McGuire.)

Mr. Davis: Same objection.

The Court: You may answer.

The Witness: A. No, I did not.

Mr. Abrams: Q. Didn't Cowan tell you that he could not state that or say that, because it was not true?

Mr. Davis: Again, the same objection. [92]

The Court: Objection sustained.

Mr. Abrams: Exception."

The witness testified further: On April 4 the round trip from the garage on Sutter Street to Van Ness Avenue and Lombard took us about twenty minutes. We left the garage at about 6:15 or 6:25 to make the trip to Lombard and Van Ness Avenue, and got back to the garage before seven o'clock.

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#### TESTIMONY OF JAMES FERGUSON

For the United States:

James Ferguson, produced as a witness on behalf of the United States, having been first duly sworn, testified substantially as follows:

My name is James Ferguson, and I am an agent of the Federal Bureau of Narcotics. On April 4 I saw the defendants, Lawrence and Margaret Brady, near the Commodore Hotel on Sutter Street. At that time I was with agent McGuire and agent Grady. I saw the defendant Lawrence Brady first. He drove his car into the garage and then went into the Commodore Hotel.

(Testimony of James Ferguson.)

"Mr. Abrams: Mr. Davis, we might do as we did before with this witness to try to shorten this up. I am directing my cross-examination of this witness entirely to what took place in the garage there. If you want to we can stipulate he will testify to that point corroborating the other officers.

Mr. Davis: All right.

Mr. Abrams: Carry on from there.

Mr. Davis: The stipulation is if this witness testified in answer to my questions up to the point of what transpired in the garage, that he would corroborate the other witnesses who have preceded him.

Mr. Abrams: Yes, because he was right along with them [93] and actually saw what they saw.

Mr. Davis: So stipulated."

The witness testified further: On the return trip from Lombard Street and Van Ness Avenue Brady's car made a left-hand turn from Sutter Street into the garage. We made a left-hand turn and followed Brady's car into the garage. As our car entered the garage I saw Mrs. Brady get out of the right-hand side of the Brady car. Our car drove into the garage and stopped behind the brady car. Agent Grady got out first. As he did so Mrs. Brady was about opposite the right-hand side door of our car, between that door and the rear fender. I saw Mrs. Brady drop a package. When I first saw the package it was in the act of falling to the floor in a straight line from her body, and it was about three or four inches from her body. Agent Grady picked the package up off the

(Testimony of James Ferguson.)

floor. I then went to the rear of the garage and to the front of Brady's automobile, where the defendant Brady and agent McGuire were. At that moment I heard agent Grady say, "I have it." Agent McGuire then told Brady he was under arrest and I put the handcuffs on Brady. U. S. Exhibit 1 for Identification, which you show me, is the package agent Grady picked up. I received that package from agent McGuire and kept it in my possession until I delivered it to the United States Internal Revenue chemist the following day.

"Mr. Davis: If the Court please, at this time we offer in evidence this brown paper envelope containing heroin wrapped in two pieces of white Kleenex, as Government's exhibit first in order in evidence.

The Court: It will be admitted and marked.

Mr. Abrams: Your Honor, may I ask—you just offered that in evidence?

Mr. Davis: Yes, because that completes the chain. [94]

Mr. Abrams: Your Honor, I was making a note here, and I did not have an opportunity of objecting. May I interpose an objection to that before your Honor admits it in evidence?

The Court: Very well.

Mr. Abrams: I object to it as incompetent, irrelevant, immaterial, illegally obtained, and in violation of the constitutional rights of the defendants.

The Court: In what manner was it illegally obtained?

(Testimony of James Ferguson.)

Mr. Abrams: Well, I raised that in my motion, your Honor, preceding the trial of this case, when I made a motion and your Honor denied it.

The Court: Objection overruled; exception.

Mr. Abrams: Yes, exception.

(The heroin was marked U. S. Exhibit 1 in evidence.)”

#### Cross Examination

I was getting out of the car when I saw the package drop. Agent Grady had already gotten out of the car.

“Q. Did you see Mrs. Brady drop the package?

A. Yes.

Q. Page 89 of the transcript. Would you mind, Mr. Ferguson, reading this, lines 21 to 23.

A. Yes.

Q. Do you remember my asking you, or you being asked by Mr. Davis, rather, in the last trial of this case, this question, and giving this answer:

‘Q. At that time did you or did you not see Mrs. Brady drop a package?’

A. I saw a package fall to the floor alongside of her hand.’

A. That is correct.

Q. Do you remember that question and answer?

A. Yes, sir.

Q. Is that correct?

A. That is correct.”

The witness testified further: [95]

“Q. Do you remember me asking you these ques-

(Testimony of James Ferguson.)

tions on cross examination at the last trial of this case and you giving these answers:

'Q. Mr. Ferguson, when did you first see the package?

A. Just as I was getting out of the car.

Q. Which side of the car did you get out of?

A. The right hand side.

Q. Where was the package when you saw it?

A. On the floor.

Q. On the floor of the garage?

A. I saw it drop to the floor of the garage.

Q. You saw it drop to the floor of the garage?

A. Yes.

Q. Or did you see it on the floor?

A. No; I saw it drop. That is what attracted my attention.

Q. Did you see where the package came from?

A. I didn't see it in her hand.

Q. You did not see it in her hand, but just saw a package dropping on the floor of the garage?

A. Yes, right within five feet of her—I mean five inches of her shoe.'

Do you remember giving those questions and those answers?

A. Yes; that is correct, I did.

Q. Now, I am asking you, this is the question: Did you see Mrs. Brady drop the package, as you just testified a little while ago, or did you just see the package on the floor of the garage, or dropping to the floor of the garage, as contained in this transcript?

(Testimony of James Ferguson.)

A. I saw the package in the act of dropping to the floor of the garage. I did not see it in her hand.

Q. You did not see Mrs. Brady drop the package? [96]

A. I did not see it in her hand.

Mr. Davis: I object to that as argumentative. He said he did not see it in her hand, but he saw it falling.

Mr. Abrams: Q. Did you see Mrs. Brady drop the package?

A. I did not see it in her hand."

The witness testified further: Agent McGuire got out the left-hand side of our car. When I saw the package dropping and Mr. Grady got to it, I was in the act of getting out of the car; I paused for a moment and then went up to where the defendant Brady was at the front end of his car.

"Q. Why didn't you stay there and assist Mr. Grady in recovering the package and placing Mrs. Brady under arrest?

Mr. Davis: I object to that on the ground it is argumentative.

The Court: Sustained.

Mr. Abrams: Q. Did you have any reason for going to the back of the garage, where Mr. Brady was, and not staying in front with Mr. Grady?

Mr. Davis: I object to that as argumentative.

The Court: Sustained.

Mr. Abrams: Exceptions to both the rulings your Honor last made."

(Testimony of James Ferguson.)

The witness testified further: I went to the back of the garage to assist agent McGuire. I did not remain to assist Mr. Grady.

"Q. You did not think Mr. Grady required any assistance?

Mr. Davis: I object to that as argumentative.

The Court: Sustained.

Mr. Abrams: Exception."

The witness testified further: When agent McGuire and I and the defendant Brady came up to where agent Grady and Mrs. [97] Brady were standing, I made the statement in front of the two defendants that I saw the package thrown to the floor of the garage.

"Q. Mr. Ferguson, why didn't you say that to them, or mention that the moment you saw the package drop?

Mr. Davis: I object to that as argumentative.

The Court: Sustained.

Mr. Abrams: Exception."

The witness testified further: When I first went to the front of the Brady car, agent McGuire and Brady were having a conversation. In a matter of seconds I heard agent Grady say, "I have it." Agent McGuire then frisked Brady for a gun and asked me to put the handcuffs on Brady, which I did; told him he was under arrest. It was a very short period of time that Mr. Brady and agent McGuire and myself were together in front of Brady's car.

"Q. About how long would you estimate it in minutes, or seconds?

(Testimony of James Ferguson.)

A. Oh, I suppose it would be a couple of minutes, maybe three minutes.

Q. A couple of minutes? A. Yes.

Mr. Davis: The witness said three minutes.

Mr. Abrams: Wait a minute, now. Let's see whether he said that.

The Witness: I didn't time it. I am just guessing at it; a short time.

Q. A couple of minutes, or three minutes?

A. Two or three minutes; maybe three minutes.

Q. Wouldn't be over three minutes?

A. That is correct.

Q. That you were down there with Brady before you had come up there where Mrs. Brady was?

A. That's correct.

Q. Page 91; 92, also, where the same thing comes in. [98]

Mr. Davis: Page 91; which lines?

Mr. Abrams: Page 91, beginning line 22 through line 24, and page 92 beginning line 14 down through 29.

Q. Mr. Ferguson, would you read those two or three lines right in there, and then over on this page, from here down to the end of the page (handing transcript to witness).

Now, Mr. Ferguson, do you recall in the last trial of this case you being asked these questions and giving these answers on cross examination by myself:

'How long were you at the front of his car?

Would you say as long as 10 minutes?

(Testimony of James Ferguson.)

A. No, I wouldn't say that.

Q. As long as 5 minutes?

A. 4 or 5 minutes.'

Then a little bit later on, I am asking you the questions again and you giving the answers:

'Q. What was going on during that 5-minute period down there in front of the car between you and Mr. McGuire and Mr. Brady?

A. Well, as soon as Agent McGuire told the defendant that he was under arrest he started to back off and I put the handcuffs on his wrist, and then we came up to where Mrs. Brady and Agent Grady were standing.

Q. Well, never mind. But you got out there—you were down there in front of the car for about five minutes. I want to know what took place at that time.'

There is an objection by Mr. Davis.

Mr. Davis: Why don't you read it?

Mr. Abrams: 'Mr. Davis: I object to the question.

Counsel is misstating the evidence. There is no record that they were there for five minutes.'

Do you really want me to read it? [99]

Mr. Davis: Yes.

Mr. Abrams (Reading): 'Mr. Davis: I object to the question. Counsel is misstating the evidence. There is no record that they were there for five minutes.'

Mr. Abrams: The agent just testified to that.

The Court: Did you say they were there for five minutes?

(Testimony of James Ferguson.)

The Witness: Maybe three or four minutes.

The Court: Maybe three or four minutes.'

Do you recall all that? A. Yes.

Mr. Davis: Of course, I make the same objection here, that this is an attempt at impeachment; it is obviously ridiculous.

The Court: The jury heard the testimony.

Mr. Abrams: A matter of two minutes is important in a matter like this about what is going on down there.

\* \* \* \* \*

Q. Mr. Ferguson, when I read this to you, your testimony in the previous trial in relation to the distance from her feet where the package was found, and you said, 'Yes, right within five—'

Mr. Davis: What page?

Mr. Abrams: Page 90, at the bottom:

'Yes, right within five feet of her,' and then you immediately said after 'I mean five inches of her shoe.' Was there any particular reason that you had in mind for saying 'five inches of her shoe' after you had said 'five feet of her'?

A. Well, I don't recall saying five feet. If I did it is absurd, because it was right within a few inches of her shoe.

Q. It is in the record here. You don't doubt you said it? [100]

A. I guess I did if it is in there.

Q. Would you say it is just a slip, or—

A. I would say just a slip, yes.

(Testimony of James Ferguson.)

Q. What you really meant to say, instead of five feet, you meant to say five inches?

A. Why, certainly.

Q. You weren't prompted in saying that by reason of anything that might have transpired in the testimony prior to your taking the stand?

A. That is absurd."

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## TESTIMONY OF JOSEPH A. MANNING

For the United States.

Joseph A. Manning, produced as a witness on behalf of the United States, having been first duly sworn, testified substantially as follows:

My name is Joseph A. Manning, and I am the District Supervisor of the Bureau of Narcotics, and I have acted in that capacity since 1921. I have been the District Supervisor of the district comprising the States of California, Nevada and Arizona since 1936. On the 4th day of April I had a conversation with these two defendants, Lawrence and Margaret Brady, in my office. The conversations began at about 11:30 and extended past midnight. I was mistaken in the previous trial when I testified that the conversations occurred about 8 or 9 o'clock. Since that time I have checked my data and I find that I was mistaken. I spoke to each defendant separately. Agent McGuire and Agent Grady were present part of the time. They

(Testimony of Joseph A. Manning.)

were in and out of the office; sometimes neither were present. I spoke to the defendant Larry Brady first.

"Q. Will you tell us to the best of your recollection what the conversation was that you had with Larry Brady on that night?

Mr. Abrams: I will make my objection here that it is [101] incompetent, irrelevant, and immaterial, not part of the res gestae, and a violation of the constitutional rights of the defendant.

The Court: Overruled; exception."

The witness testified further: Agent McGuire had handed me a package, an envelope containing heroin. It was lying on my desk. Brady was across the desk from me. I asked him where he got this heroin. He said he got it from a fellow on Van Ness Avenue, and that he paid \$300 for it; that he had spent large amounts of money in making purchases of heroin, and that it was badly adulterated. He called it "flea powder." He told me his wife accompanied him to Van Ness Avenue and Lombard; that she left the car at that point; that he drove on three or four blocks where he met the man from whom he obtained the heroin. Brady then made the proposition to me that if I would turn him loose and his wife loose and release the car, that he would help me catch other peddlers of narcotic drugs, peddlers more important than I knew about. I told him I could not very well accept such a proposition as that. I told him if he would help me catch these peddlers I would inform the United

(Testimony of Joseph A. Manning.)

States Attorney of that fact, and the United States Attorney would doubtless make such fact known to the Court, and that a lighter sentence in the case would be given him. He would not agree. He said if he or his wife went to jail and he lost his car he would "just as soon go all the way as get just, say, a small sentence." I told him that I didn't have the power to turn him loose under the circumstances. I then questioned Mrs. Brady separately under the same circumstances, the same time and place, and with the other agents in and out of the room.

"Q. Will you tell us to the best of your recollection what the substance of the conversation was that you had with [102] Mrs. Brady?

A. I asked her where she obtained the package.

Mr. Abrams: The same objection as interposed to the prior conversation, your Honor; it is incompetent, irrelevant, and immaterial, not part of the res gestae, and a violation of the constitutional rights of the defendants.

The Court: Overruled.

Mr. Abrams: Exception."

The witness testified further: Mrs. Brady said that when her husband drove the car into the garage she picked the package up off the seat of the car. It was between them. She got out of the car, and when she saw the agents she threw it to the ground. She said she had intended to take it up to her room in the hotel.

U. S. Exhibit 1 in evidence, which you are show-

(Testimony of Joseph A. Manning.)  
ing me, is the package which was lying on my des'  
and the one that I asked Brady where he got it.

### Cross Examination

This conversation with Brady occurred at my office on Post Street between 11 and 12 o'clock at night. At the first trial of this case I testified that the conversation took place at about 8:30 or 9 o'clock in the evening. I first realized that I was mistaken as to the time of the conversation soon after I left the courtroom during the first trial. The agents reminded me they had been trying to get me on the phone all evening, and I remembered I had attended a show that evening. When Agent McGuire called my attention to the fact I had testified wrongly about the time that the conversation occurred, I readily remembered that they had held the prisoners while waiting for me to talk to them. The notes that I glanced at very briefly at the beginning of my testimony during the previous trial did not contain a notation [103] as to the time the conversations were held with the defendants.

“Q. Now, Mr. Manning, you mentioned the words ‘I will go all the way’ in your testimony just a few minutes ago, in saying that Mr. Brady said he might as well go all the way and for a trial, and everything else; is that correct, you just said that?

A. Mr. Brady said when he propositioned me to help in catching peddlers, he in the course of that conversation remarked, ‘If I agree to help you I will go all the way with you.’

(Testimony of Joseph A. Manning.)

Q. That is correct, that is what you testified in the last trial of this case. A. Yes."

The witness testified further:

"Q. Now, Mr. Manning, it is true you have not the power to turn a man loose that you arrest for some violation; is that true, you have not got that discretion vested in you?

Mr. Davis: If the Court please, I will object to this line of testimony as being incompetent, irrelevant, immaterial, having no bearing on the issues in this case. The ultimate fact is that these defendants were arrested. Whether he has or has not the power to release anyone else is immaterial.

The Court: The objection will be sustained.

Mr. Abrams: It is a part of the conversation.

The Court: The Court has ruled.

Mr. Abrams: Exception.

Q. As a matter of fact, you have, in the course of your duties, in an effort to catch higherups and reach the source of supply of narcotics, you have turned certain defendants, or persons you have arrested or had under observation, or believed to be trafficking in narcotics, you have turned [104] them loose or given them some consideration afterward, or agreed to do that?

Mr. Davis: The same objection upon the ground already stated, and I make the objection it is compound and complex.

The Court: Sustained.

Mr. Abrams: Exception.

(Testimony of Joseph A. Manning.)

Q. As a matter of fact, it is your policy to reach the source of supply of narcotics and reach the higherups and arrest them; isn't that true?

Mr. Davis: I interpose the same objection.

The Court: Sustained.

Mr. Abrams: Exception.

Q. You would not turn down a proposition, would you, that is given to you by somebody who, you might say, might be just found in possession of narcotics, or might be just presumed to be a user of narcotics, you would not turn down a proposition from such a person, which might involve the turning up of a source of supply of narcotics and the apprehension of higherups, you would not turn down that kind of a proposition, would you?

Mr. Davis: I make three objections to that, your Honor. First, it is compound and complex and unintelligible; second, it is argumentative; third, it is incompetent, irrelevant, and immaterial.

The Court: The objection is sustained.

Mr. Abrams: Exception.

Q. But you did turn down the proposition here that they made to you of turning up the source of supply of narcotics and some big shots, you did turn down that proposition? A. I did."

The witness testified further: Agent McGuire did very [105] little talking while I was talking to the defendant Brady. I asked Brady how much he had paid for the heroin, U. S. Exhibit 1 in evidence, and he told me \$300. I don't recall McGuire say-

(Testimony of Joseph A. Manning.)

ing to Mr. Brady, "Larry, I guess you paid about \$300 for that stuff."

Mr. Abrams: Q. Isn't it a fact Mr. McGuire was asking questions in such a way as to draw from Mr. Brady simply a 'Yes' or 'No' answer, or a nod, or gesture of some kind?

Mr. Davis: The same objection.

The Court: He may answer.

The Witness: A. I was doing the questioning, not Mr. McGuire.

Mr. Abrams: Q. Wasn't Mr. McGuire putting words in Mr. Brady's mouth?

Mr. Davis: I object to that as argumentative.

The Court: Sustained.

Mr. Abrams: Exception.

Q. Isn't it a fact, Mr. Manning, that Mr. Brady said something like this to you, or in your presence: 'If you are going to file some charge here why don't you file it against me and leave my wife and the car out of this thing?'

A. He didn't make any such statement as that. He wanted to—I will take that back. He did ask me—in the beginning, in his proposition to help he wanted himself and his wife released, have the car returned if he did anything to help in detecting and apprehending others."

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The Government rested its case in chief.

"Mr. Abrams: Your Honor, I want to make the usual motion for directed verdict on the ground of

insufficiency of the evidence, and furthermore, to the improper admission of the evidence in this case of Government's Exhibit 1, on the ground it is a violation of the constitutional rights of [106] the defendants. May I have just a few minutes to present the matter to your Honor in the absence of the jury?

The Court: The jurors may retire.

(Thereupon the jury retired from the court-room.)

Mr. Abrams: Your Honor, I did not present this point to you by way of argument in the previous trial of this case, for which I think I was negligent. The more I think of this point the more I think I am right in my contention, and I think I should present the matter to you a little more fully. I raised several points here, one on the question of search and seizure, the violation of constitutional rights of the defendants; another point on the insufficiency of the evidence.

On the first point of the constitutional rights of the defendants of search and seizure, we know the courts have ruled that the Federal officers cannot make a lawful arrest, or an arrest is not lawful unless the officer at the time of the arrest—let me put it this way: The arrest, first of all, must be lawful, and a search must be made subsequent or following the arrest, as an incident of the arrest, at or about the time and place of the arrest, in order to be upheld under our authorities.

Now, a lawful arrest is one where the officer has

a warrant of arrest properly obtained, or where he has reasonable or probable cause to believe that a felony has been committed by the defendant, or where he observes a felony or a misdemeanor committed in his presence. I think that is the more general rule of law pertaining to lawful arrest. Here the question comes down to the fact whether or not the officers had reasonable and probable cause to believe a felony had been committed by the defendants, or did the [107] officer see a felony committed in his presence, or a misdemeanor. I don't think any of those things, under these circumstances, exist, your Honor. The testimony here reveals subsequently that the officers followed the Bradys out to Van Ness Avenue and back into the garage, and on entering the garage they immediately placed the two defendants under arrest. There isn't much more to it than that. Following which the officers found a package on the floor. Let's take it at its ~~worst~~. Two officers say they saw a package drop as they were getting out of the car. The officers did not know what was in that package. They did not know anything about the package. They did not know its contents, or have any reason to know anything about its contents. The package in appearance was nothing more than any other package which could contain anything of a lawful nature. The officer did not discover what was in the package until after he had opened it, until after he had violated the constitutional rights of the defendant.

What an agent discovers after an unlawful arrest and search, what it may bring to light does not avail the officer anything and he can't make any use of it. It should be quashed. So that all the officers saw or knew before they arrested the defendants, they saw them drive out to Van Ness and Lombard, saw him let her out, and pick her up and bring her back to the garage, and saw a package drop, together with the fact they knew the defendants, and the defendants knew them. Under the cases, that is not proper information, your Honor; that is not reasonable or probable cause to believe there is a crime, or a felony has been committed by these defendants.

(Further argument.) [108]

The Court: The motions and each of them will be denied.

Mr. Abrams: Exception.

The Court: Bring back the jury.

(The jury was then returned to the court-room.)

The Court: Waive the roll call, stipulating and agreeing all the jurors are present and seated in the box?

Mr. Davis: Yes, your Honor. If the Court please, may your Honor's ruling on the motions previously made in the presence of the jury be ruled upon in the presence of the jury?

The Court: The motions, and each of them, will be denied.

Mr. Abrams: I presume my exception is in the record."

## TESTIMONY OF IRVING COWAN

For the Defendants.

Irving Cowan, produced as a witness on behalf of the defendants, having been first duly sworn, testified substantially as follows:

My name is Irving Cowan. I am presently in the custody of the Sheriff of the City and County of San Francisco serving a one-year sentence on a charge of possession of narcotics, heroin, having been arrested by Agent McGuire of the Federal Narcotics Bureau in February of this year. I was originally booked on a Federal charge, which was later changed to a State charge. When I testified in this case at the last trial, my own case was then pending, and at that time I was out on bail. I am now serving a one-year sentence. I was arrested by Agent McGuire on Polk and Turk Streets, San Francisco, during the month of February of this year, and taken to my room at the Embassy Hotel. When we got there, my wife and Mrs. Brady, the defendant here, were at the room in the Embassy Hotel. While we were at my room [109] Mr. Brady, one of the defendants, telephoned. Agent McGuire asked to speak to Mr. Brady, and upon doing so told him to come up to the room. Mr. Brady came up. My wife and I had had an appointment to have dinner on that evening with Mr. and Mrs. Brady. That was the reason for Mrs. Brady being at the room. I have known Mrs. Brady between two and three years, and I have known Mr. Brady between three and four years. I

(Testimony of Irving Cowan.)

was employed as manager of the Continental Club, here in San Francisco, owned by Mr. Brady, and also acted in the same capacity for Mr. Brady at his place of business in Reno, Nevada. I lived in their home in Reno and I acted as the best man at their wedding. Subsequent to my arrest I met Agent McGuire quite a few times, mainly during the time my case was pending at the Hall of Justice, San Francisco. In a conversation had with him on the afternoon of my arrest he told me, "You are just a small fry. We don't want people like you. Why don't you do what we tell you to and you will get very little time, if any at all. Just do as we say." I asked him what he wanted from me. He asked me to sign an affidavit stating that the package that I had in my possession at the time of my arrest was for the defendant Brady. I told him I could not say that, because Brady was not involved and knew nothing about it. He said, "Well, if you want to be a damned fool, go ahead. That's the way we arrested you; somebody put their finger on you." I told McGuire that Brady had nothing to do with it. He took me to the jail and booked me. The next morning I obtained bail.

"Mr. Abrams: Q. Go ahead.

A. On the morning that I appeared at the Hall of Justice Mr. McGuire met me in the hallway before we went into court. He said, 'Irving before they bind you over for Superior Court,' he said, 'this is the time for you to do something for us.'

(Testimony of Irving Cowan.)

He said, 'If you do [110] what we want you to we will be lenient with you; if you don't,' he said, 'we will go on the stand and tell the judge you are a peddler; we will get you as much time as we want.' I said, 'Mr. McGuire, I don't know what I can do for you. These people you want me to say anything against have nothing to do with this.' He said, 'If you want to be a damn fool you will just have to do that.' So I went into the preliminary examination. Another time up there he came up to me on the morning—

Mr. Davis: Just a minute. What day is this?

A. The morning after Mr. Brady's arrest."

The witness testified further: Every time I saw Agent McGuire that is what he kept telling me, that he wanted me to involve Brady.

"Mr. Abrams: Q. Let me ask you this: Before Mr. Brady's arrest did Mr. McGuire ever make any threat in front of you to arrest Mr. Brady?

A. Yes, quite often. He told me, he said, 'I am going to get him.'

Mr. Davis: When was this?

A. Several occasions.

Mr. Davis: Let's get the first one. Who was there?

Mr. Abrams: Q. As best you recall; state it as best you recall.

A. Well, it was up in the corridor, there, whenever he talked to me; he talked to me every time he saw me.

(Testimony of Irving Cowan.)

Mr. Abrams: Q. Where did it take place?

A. In the corridor of the Hall of Justice.

Q. Who was present?

A. Mr. McGuire and myself.

Q. Approximately how long after the time you were arrested?

A. Well, they started—

Q. I am talking about this conversation, the conversation of [111] this threat that I am talking about; approximately how long after you were arrested?

A. The first time was when we left the hotel, when he took me to the jail and booked me.

Q. What did he say then?

A. He said, 'I am going to get Brady.' He said, 'If you don't help me I will get him by myself.'

Q. What is the next time?

A. Next time was when I saw him out in the corridor, he called me up one day.

Q. Called you up one day?

A. Yes.

Q. When was that? How long after you were arrested?

A. A week or ten days before I appeared; I was at my hotel room.

Q. At your hotel room where?

A. At the Commodore.

Q. You recognized his voice on the phone?

A. He told me it was him.

Q. What did he say?

A. He said, 'Are you ready to do as I asked you to?' I said,—first, he says, 'Did you talk to your

(Testimony of Irving Cowan.)

attorney?' I said, 'No, I have not.' He said, 'Well, are you ready to do as I asked you to?' I said, 'No, I can't do that.'

Q. At any other time did he tell you anything about arresting Brady?

A. Yes. He told me up in the corridor when I met him—

Q. At the Hall of Justice?

A. At the Hall of Justice.

Q. About how long after the time you were arrested?

A. Oh, around three weeks, two weeks afterward.

Q. What did he say to you then?

Mr. Davis: Who was present, if anyone?

Mr. Abrams: Who was present?

A. Mr. McGuire and sometimes Mr. Grady.

Mr. Davis: Sometimes. We are talking about one specific conversation. Which one? [112]

Mr. Abrams: All right. Never mind arguing with the witness.

Mr. Davis: I am not arguing with him.

Mr. Abrams: Q. Do you recall anyone else being there at the moment of this conversation I am asking you about? A. No.

Q. Just you and Mr. McGuire?

A. Yes.

Q. What was said then?

A. He told me he was out to get Brady and he was going to get him, and if I didn't help him it would be just too bad for me, and he would get

(Testimony of Irving Cowan.)

him sooner or later, and if I was smart I would help myself and help him, too.

Q. At any time did he indicate to you when he would get him? A. No."

The witness testified further: In the corridor of the Hall of Justice when I appeared for one of my preliminary examinations, before I was sentenced, Agent McGuire said to me, "Before you go to trial I will have Brady in jail with you." On the morning following Brady's arrest Agent McGuire and I had another conversation in the Hall of Justice. I had to appear in court that morning. Agent McGuire said to me, "Well, I got Brady last night." He said, "He lost his Cadillac. It looks like he will get a lot of time." He said, "Why don't you wake up? You can't do Brady any harm now." He said, "Why don't you go before the grand jury and tell them where you got that package, and that it was for Brady?" I said, "Well, I couldn't do that." I said, "I would only be involving him in something he had nothing to do with." About that time my attorney came up and he said, "What's the matter with that silly bastard? Why don't he do what we want him to?" He said, "If he don't he is going to get a year in jail. Otherwise we will see he gets three months." My attorney [113] said, "Well, I couldn't hardly think a man would do that." He said, "Well, I'll go on the stand," he said, "and just rap the devil out of him," and they went off to the side to talk some more, and Mr.

(Testimony of Irving Cowan.)

Grady came over to me and he said, "Why don't you quite being a damn fool?" he said. "You can walk into the Post Office Building," he said, "and nobody will see you go in or out. All you have to do is go up and testify before the grand jury, nobody will know anything about it." He said, "Nobody will know you ever done anything like that." I *told* I would be sending an innocent man to jail and I am not the type to do a thing like that. That about covers all the conversations I had with Agent McGuire. Agent McGuire appeared as a witness and testified against me at my trial in the State court.

"Mr. Abrams: Q. Did he state in your presence at that time to the judge in that court that you testified in this trial previously?

A. He did.

Mr. Davis: I object. I will ask, your Honor, that the witness be instructed to allow me to state my objections before he answers the questions, because it is obviously leading, and very incompetent, irrelevant, and immaterial.

Mr. Abrams: It all goes to the bias and prejudice of the witness, your Honor; the credibility.

The Court: The objection will be sustained; let it go out.

Mr. Abrams: Exception.

The Court: The jury will disregard it.

Mr. Abrams: Q. Did he represent to the judge in that court at the time of your sentence, did he state to the Court you were a peddler?

(Testimony of Irving Cowan.)

A. Yes.

Mr. Davis: I make the same objection.

The Court: Did you enter a plea? [114]

A. No, I did not. I plead not guilty.

The Court: Proceed.

Mr. Abrams: That is all along that line. Now, Mr. Cowan, incidentally, that was your first conviction, was it not, on a charge of narcotics?

A. It was."

The witness testified further: On April 4, 1944 I was living at the Commodore Hotel in San Francisco. The defendants, Lawrence and Margaret Brady, were also living at the Commodore Hotel. On that day I saw them drive into the garage across the street a little after 6:30 p. m. At that time I was standing in front of the Commodore Hotel. Brady was going to allow me to use his Cadillac automobile that night, saying that he would be back from the race track around 6 o'clock, so I was waiting in front of the hotel for Brady to return. When I saw Mr. and Mrs. Brady drive into the garage across the street, I started to cross the street to the garage. At that time I observed another car with Mr. McGuire and Mr. Grady drive up to the entrance of the garage. I immediately recognized them. This photograph you are showing me, Defendants' Exhibit D, is a picture of the front of the garage. The ramp you see there is on the downhill side of the building. At that time I saw a fellow I knew just coming out of the ramp of the garage,

(Testimony of Irving Cowan.)

or he had been standing there. I seemed to see them all at once. He tossed a package over towards the grease rack, just a little past this post shown here in Defendants' Exhibit B, which you are showing me. The package was white; it looked like an envelope or a handkerchief. I couldn't tell what it was. It was a small package. He just sort of tossed it. This man's name is Frenchy, and I had previously purchased narcotics from him. I had seen that man in that vicinity before. Whenever I bought anything from him I used to have to go to North Beach the night before, and I would meet him, [115] and after I found him I would give him the money and he would meet me on Sutter Street, close to the garage, and deliver it to me. After this man tossed that package, he started to walk out, down the street, and I tried to stop him. I didn't know what was taking place at the time. I sort of yelled at him, "Wait a minute." He said, "I'll see you later." He got in a car and drove off. The car had been parked just a little way down Sutter Street from the garage. I had seen Mr. Grady jump out of the car and grab hold of Mrs. Brady's arm. After I tried to stop Frenchy, I turned around and went back toward the garage to see what was taking place, and Mr. Grady and Mrs. Brady were standing there talking, and it seemed like they started to turn around and go back to the back of the garage when he stooped over and picked up the package. He said something. The package was a few feet away from Mrs. Brady.

(Testimony of Irving Cowan.)

When I seen him do that, I turned around and went back to the hotel and went to my room and stayed there until about 7:30. During that afternoon I had gone to see somebody at a card club on Eddy and Taylor Streets. I returned to the hotel between 4 and 5 o'clock. I did not see Agent McGuire in front of the hotel or in that vicinity at that time when I entered the hotel. Mr. and Mrs. Brady, the defendants, do not know this man Frenchy. The day I got out on bail after my arrest I had a conversation with Mr. Brady in which I told him I had just started using narcotics not long before this time. He was very angry with me for having done so.

#### Cross Examination

Between the time of my arrest and the time when I testified at the first trial of this case, I had around five or more conversations with Agent McGuire. Agent Grady was present at some of these conversations. At one conversation in the Hall of Justice my lawyer was present. He arrived about the middle of [116] the conversation. Agent McGuire and my lawyer stepped over to the side and had another conversation. My lawyer recounted this conversation to me, and it was in substance the same conversation that Agent McGuire and I had had before the arrival of my lawyer. The subject of all of my conversations with Agent McGuire between the time of my arrest and the first trial of this case was that Agent McGuire wanted me to testify before the Federal Grand Jury that the

(Testimony of Irving Cowan.)

narcotics found in my possession at the time of my arrest were for Mr. Brady.

"Q. On the night you were arrested, it is a fact, is it not, you left the La Salle Hotel and went over to around Broadway and Columbus Avenue?

A. I did not.

Q. You did not? A. No.

Q. Well, it is a fact, is it not, you purchased the narcotics in the barber shop at—

Mr. Abrams: If the Court please, Mr. Davis, I presume, is now going into the facts of this man's case. It is not proper cross examination. It is not part of this case. We took nothing like that up on direct examination of this witness. Mr. Davis is examining this man as to his own case.

Mr. Davis: Mr. Abrams opened up this entire line of testimony as to what took place on the night he was arrested up in the room, the conversation had, and what was said on the street, and who was up there when he got there, and going into the bathroom and being searched. I am entitled to find out what happened.

The Court: Any testimony gone into on direct examination may be inquired into on cross examination.

Mr. Davis: Q. That is a fact, is it not?

Mr. Abrams: Exception. [117]

Mr. Davis: Q. That on the night you were arrested you purchased the narcotics over in a barber shop around Columbus and Broadway?

(Testimony of Irving Cowan.)

A. That's right.

Q. It is a fact, is it not, you purchased them from a man by the name of Tea John, who is known as Tea John?

A. I don't know the man's name for sure.

Q. Did Mr. McGuire ever tell you that the man you had bought from was nicknamed 'Tea John'?

A. He told me some name there.

Q. Isn't it a fact, Mr. Cowan, that all of those conversations you had with Mr. McGuire, what he asked you to do was to go in and testify that you had purchased the narcotics from Mr. Tea John, and that he did not ask you to come in and testify that you had bought them for Mr. Brady?

A. No, he did not. He asked me to say they were for Brady.

Q. Did he ask you at any time to come in and testify, or even to tell him that you had purchased the narcotics from this Tea John, whom he named and whom he suspected to be a peddler?

A. Yes.

Q. He asked you that?

A. He asked me—he never mentioned the name but once, but he always referred to him as "parties."

Q. So according to your testimony, what he asked you was to come in and testify that on that night you had gone to a place to purchase narcotics from some definite person and that you were taking them back to deliver them to somebody, namely, Mr. Brady?

(Testimony of Irving Cowan.)

A. I did not understand you. \* \* \* Yes."

The witness testified further. On the afternoon of April 4 I left my room in the Commodore Hotel at about 3 o'clock in the afternoon, or a little earlier, and went to Eddy and Taylor Streets. I returned to my room in the hotel sometime between 4 [118] and 5 o'clock. I stayed there until 6:30, when I came down from my room and waited in front of the hotel for Mr. Brady to return so I could borrow the Brady automobile to use on that evening. I observed Mr. Brady, accompanied by Mrs. Brady, drive his car into the garage. At that time I did not see the Government car, but as I started to walk across the street I noticed it pull into the garage. I did not recognize anybody in the Government car until I got a little closer. At this time I saw Frenchy, whose full name I knew at one time but do not know now. I did not know his full name at the last trial, either, of this case. When I first saw Frenchy, I was between the car track and the sidewalk. At that time he was making the turn from the garage, coming out the ramp. As he was coming right out of the ramp I saw him toss a package. The package traveled around ten feet or so. At this time both the Brady car and the Government car were in the garage towards the back. I did not see any people moving around the cars, but Mrs. Brady was up near the front of the garage. I saw Mr. Grady standing holding Mrs. Brady's hand, arm, talking to her. It all seemed

(Testimony of Irving Cowan.)

to happen all at once. Frenchy threw the package and kept walking around the corner toward his car. That is when I tried to stop him and talk to him. I did not see where the package landed, but it was in the direction of the grease rack. Mr. Grady stooped over and picked something up within a few feet from Mrs. Brady.

"Q. You don't know where this package that you saw tossed landed in the garage?

A. Well, I didn't see just the exact spot, I mean.

Q. You don't know whether it landed near Mrs. Brady or away from her, or where it landed?

A. Well, it was in that general direction.

Q. In that general direction?

A. Yes. [119]

Q. All you know is you saw a package tossed, you don't know where it landed?

A. That's right.

Q. Then you saw Mr. Grady stoop and pick up something from the floor?

A. A few minutes later, yes.

Q. You don't know, of course, whether what he picked up was the package? A. Pardon?

Q. You don't know, of course, whether what he picked up was the package?

A. No, I don't." [120]

TESTIMONY OF LAWRENCE WILLIAM  
BRADY

One of the defendants.

Lawrence William Brady, one of the defendants, produced as a witness in his own behalf, having been first duly sworn, testified substantially as follows:

My name is Lawrence William Brady. I am 38 years old. I formerly operated and conducted a business in Reno, Nevada. It was a combination of a night club and had gambling, slot machines, a bar, which are all legal in Nevada. Mr. Cowan was employed by me in the capacity as manager. He also resided with me and appeared as the best man at my wedding. I formerly operated a business here in San Francisco known as the Continental Cocktail Lounge, at 127 Ellis street. Mr. Cowan worked for me there for about eight or nine months, as manager. I joined the Merchant Marine on February 9, or thereabouts, 1943. I sailed on a ship from San Francisco on approximately that date. The ship was destined for Guadalcanal. En route I was ruptured in the line of duty one evening while some oil or gasoline barrels got loose in a rough sea, and a gang of us had to go out and make them fast to keep them from rolling all round. I got ruptured on my left side. As I fell I hurt my back at the same time. When the ship reached Honolulu, pursuant to doctor's orders I left the ship and received hospital treatment at Honolulu. I was told that I needed an operation, and was advised to return to San Francisco to the Marine

(Testimony of Lawrence William Brady.)

Hospital to receive medical care on account of the crowded space and limited facilities which were greatly overtaxed in Honolulu by reason of the return of men who had been wounded overseas. I was given passage back to San Francisco on a Liberty ship, and upon my arrival in San Francisco went to the Marine Hospital, where a week or so later I was operated on by a Dr. Hunt at the Marine Hospital. I was convicted of a felony in 1925, when I was 19 years old. The felony was [121] robbery. I was also in some difficulty in Reno, Nevada, where I pleaded nolo contendere on the advice of counsel. I do not know whether that charge amounted to a felony. The trouble grew out of a fist fight that ensued in the Bank Club, Reno, Nevada. There was no arrest made at the time, but subsequently a charge was placed against me for possession or transportation of a gun in interstate commerce, a Federal charge. After pleading nolo contendere I was placed on probation for one year, at which time, according to the probation officer's report, the case would be dismissed. My counsel advised me to plead nolo contendere and accept this probation. At the time of my arrest on April 4, 1944, I had a number of mutual tickets issued at the Bay Meadows race track in my possession. I also had a substantial sum of money on my person. Since I have been unable to work, in order to keep up in funds I have been commissioning bets on horse races, and naturally I have to have large amounts of money with me in order to work. The

(Testimony of Lawrence William Brady.)

bets I had been making were for other people. It was other people's money that I had. The mutual tickets that Mr. McGuire took out of my pocket were dated April 4th, the same day of my arrest. On that day I was driving a Cadillac 1941 sedan, Model 63. It was my car and fully paid for. Mr. McGuire took that car from me in the garage that night, and I imagine it is still in the custody of the Government, as they have not returned it to me. On April 4th I was living at the Commodore Hotel, on Sutter street, with my wife. I kept the car in a public garage across the street at 840 Sutter street. I know Mr. McGuire, the narcotics agent. I first met Mr. McGuire at the Sir Francis Drake Hotel, while I was residing there for a couple of weeks, in December of 1942 or January of 1943. At that time Mr. McGuire accused me of having narcotics in my possession, and he searched my room in the Sir Francis Drake [122] Hotel. He did not find any narcotics in my possession, or in my hotel room. On April 4, 1944, I returned to the Commodore Hotel from the race track at approximately 6:00 o'clock. I put my car in the garage across the street from the Commodore Hotel and immediately went to my room in the hotel. My wife was there. I told her that I was tired and that I was about to retire in order to get a good night's rest. She said, "I was in the beauty shop this afternoon and I heard a woman say there was an apartment for rent out on Van Ness Avenue and Lombard." She did not say how far. At that

(Testimony of Lawrence William Brady.)

time she just said, "Out at Van Ness Avenue." She said, "Will you drive me out there before you retire?" She said, "We have been trying for quite some time, we are living in a hotel and trying for some time to get an apartment where we can cook for ourselves and make coffee and things, we are tired of living in hotels, we have been looking around for an apartment." I was only too glad to drive her out there. It was a possibility we could have an apartment. We left the hotel, went to the garage, got the automobile, and drove out to Van Ness and Lombard. While driving to that point I looked in the rear view mirror, and in my own mind I thought I seen Mr. McGuire's green coupe that he usually drives around in, and I mentioned it to my wife. She turned around and she agreed with me that it looked like the same car, and we both agreed that it could be the same car. I made several different turns, sort of a zigzag course. I did that purposely to determine whether or not this car was following me. We were satisfied in our own mind that we were being followed. When we got to the corner of Van Ness and Lombard I stopped the car. My wife got out of the car. I had been having trouble with the hood of my automobile. The catch that locked the hood had been broken and it caused the hood to rattle and jump up and down. I [123] had had it welded by a mechanic once before, but the trouble occurred again, so that I was desirous of having it repaired. When

(Testimony of Lawrence William Brady.)

my wife got out of the car at Van Ness and Lombard I told her that I was going to drive to the corner of Van Ness Avenue and Bay street to see if I could get a mechanic to fix the car while she was looking at the apartment. I told her that I would not be gone long. I said, "I am going to see if I can get this hood fixed while you are looking at the apartment. I'll drive up here and see if I can get it fixed. Be back as soon as you can, don't be too late, because I promised the car to somebody." I drove to Van Ness Avenue and Lombard, but I was unable to find a mechanic. I made a U-turn at that point and returned to Van Ness Avenue and Lombard, where my wife was standing on the corner. I made a left-hand turn, stopped and picked her up, and drove back to the garage, drove into the garage. I drove approximately two-thirds of the way back toward the back part of the garage and then I stopped the car. It was past the place where the office is in the garage. I did that deliberately in order to get out of the way so I wouldn't be blocking traffic at the gasoline pump. I was going to try to fix the hood, myself. There was no mechanic on duty at that time in the garage. I asked my wife if she would go across the street and tell Cowan that I was having trouble with the hood, that I was attempting to fix it, and if Cowan wanted the car to come over to the garage. My wife got out of the car. I then got out of the driver's seat and walked around to the front of the car and was attempting to lift up the hood, or attempting to get

(Testimony of Lawrence William Brady.)

the hood released so I could get it up and either fix it or get it back down, when Mr. McGuire walked up, accompanied by Mr. Ferguson. Mr. McGuire, at the hood of my car, started diving through my pockets. [124]

"Q. What?

A. Starts reaching his hands into my pockets and says, 'Where is it, Larry, where is it? Come on, we got you. Give it to us now. Where is it?' I backed away. I says, 'Where is what, Mr. McGuire? What are you doing, putting your hands in my pockets?' He says, 'You know what we are talking about. Come on, where is it? Give it to us.' I said, 'I don't know what you are talking about, Mr. McGuire. I don't know what you are talking about, Mr. McGuire,' I said, 'I don't want you to put your hands in my pockets. Please don't do that.' That's when I backed away. He mentioned something about a knife. He reached in my pocket and took out a pocket knife. I wish he would produce that. I haven't seen it since then. It was not among my belongings in the jail. I haven't seen the knife since. It was merely a pocket knife.

Q. How about a gun, did you have a gun?

A. No. I never have a gun in my possession, in my car, or anything.

Q. Did he search you?

A. Yes, he put his hands in my pockets, all of my pockets, every one of them; maybe with the exception of the little watch pocket, for something that he didn't find. He took out my money, the

(Testimony of Lawrence William Brady.)

bills, and seemed to be so cautious of the bills. He said, 'I have been accused before, we have to be awfully careful of this money,' but took the money, and pulled out my handkerchief and wrapped it in there. He says, 'There is your money, so you won't give me any argument about the money.' He put it back in my pocket, my handkerchief back in my pocket, this pocket (indicating). He went through all my pockets and my wallet and took this knife, as I said.

Q. Were you handcuffed?

A. Yes. Mr. Ferguson put those—while he was going through my pockets—I had [125] been warned that Mr. McGuire wanted to arrest me, and had been trying to arrest me, and was going to arrest me. I was told that, and so when he started putting his hands in my pockets I asked him, I said, 'Let me see your hands?' He said, 'What are you doing?' We were having quite a little tussle there about him putting his hands in my pockets. I said, 'I don't object to you putting your hands in my pockets, or searching me.' I said, 'All I want to do is just see your hands.' He said, 'Yes. What are you trying to insinuate?' I said, 'I am not saying anything about that, Mr. McGuire, I am just merely trying to be careful with you and asking you to see your hands. Then you can go through my pockets and search me completely.' Then he insisted that Mr. Ferguson put the handcuffs on me, so the handcuffs were put on.

(Testimony of Lawrence William Brady.)

Q. Did you hear Mr. Grady shout out anything around that time?

A. Well, yes. After all of that transpired, all of that had happened there in front of the car and the handcuffs were placed on, Mr. Grady hollered something, I presume it was Mr. Grady, 'O.K., Mac, I have got it,' or words to that effect. Or, 'O.K., here it is, I got it,' something to that effect.

Q. How long a time elapsed, could you estimate, before you heard that shout?

A. Well, I would say at least, it couldn't possibly be less than four or five minutes. From what took place in the conversation and the searching of my pockets, it was at least four minutes, at least four minutes, possibly five.

Q. Were you then taken to the front part of the garage, where Mrs. Brady and Mr. Grady were?

[126]

A. Yes. Immediately following Mr. Grady hollering to the back, McGuire and Agent Ferguson took me up to where Mrs. Brady and Mr. Grady were standing, and he handed Mr. McGuire a white package, said something, 'Here it is,' or 'I seen her throw it on the floor,' or 'I seen it on the floor,' words to that effect. I don't know just exactly what he did say, but he handed the white package to him, and McGuire first showed it to my wife and said, 'Did you drop this, Margaret?' or 'Is this yours?' 'I don't know anything about it,' she said; 'I absolutely don't know anything about it. It isn't mine, and I never seen it before.' Then he turned to me

(Testimony of Lawrence William Brady.)

and he says, 'Is this yours? Do you know anything about this, Larry?' I says, 'I absolutely don't know anything about it, I have never seen it before, I haven't anything to do with it.' So then he says, 'Well,' he says, 'this happens to be narcotics and I am placing you under arrest, and your wife under arrest, and you lose the car.' "

The witness testified further: My wife and I were then taken to our room in the Commodore Hotel, across the street, by Mr. McGuire, Mr. Grady, and Mr. Ferguson. The room was searched completely by the officers. I emphatically denied that I had bought the narcotics, U. S. Exhibit 1 in evidence, on Van Ness Avenue for \$300. Mr. McGuire was the one who made that suggestion.

"Q. How did he suggest it to you?

A. While Mr. Grady and Mr. Ferguson were searching the bathroom and the suitcases in the closet, and everything, Mr. McGuire sat down on the bed and he said, 'Well, now, Margaret'—meaning my wife—'you know you are on the spot in this case. You are the one that is in bad. Mr. [127] Brady hasn't been found within 60 feet of this stuff. This stuff was picked up right next to you and the agent said he seen it falling on the garage floor.' He said, 'You are the little girl that is on the spot; he isn't. Then he says, turning to me, he says, 'If you are half the man I think you are you ain't going to let this little girl ride the beef on this. No use of you both going down.' I said, 'Well, Mr. McGuire, you have been telling people you are going

(Testimony of Lawrence William Brady.)

to get me, you are taking my car away from me and you are going to put me in jail. Somebody has convinced you I am a narcotics user. No matter what I can do I can't prove to you, or convince you, I am not a user, that I have nothing to do with narcotics, so I am the one you are after. Why do you want to take and embarrass my poor little wife, and harass her, and have her go down there and on trial and cause her all this embarrassment? My wife is innocent.' My wife was on the spot, my poor little wife right there, like he said.

Q. Don't get excited now, Mr. Brady.

A. He turned the whole thing around and says I was trying to get leniency for myself. I was not thinking of myself. I was not found within sixty feet of the package.

Q. You say he said something to you, something about \$300?

A. He said, 'The price of this stuff now, you must have paid at least \$300 for that.' I said, 'I never paid anything for it.' I said, 'I have never seen the package before; I don't know anything about it; I have nothing to do with narcotics.' I said, 'You know, you searched my room in the Sir Francis Drake Hotel a year and a half ago, you never found any narcotics and you got me in front of people there, you met me in the lobby of the hotel when I was going out with a suit- [128] case in my hand, my wife and I.' He says, 'Somebody told me you are a user of narcotics,' He said, 'Larry, you know—' He talked to me like I was

(Testimony of Lawrence William Brady.)

his brother. He said, 'Larry, you know I have no search warrant, or nothing, but,' he says, 'if you are not a user you should not have any objection to us going up and looking through your room, your personal belongings. If you are not a user you will want that. You will want to declare that.' I said, 'I certainly do, Mr. McGuire, if that is the case.' I said, 'This is a little embarrassing here in the lobby, and I would much rather go up to my room and you can search it thoroughly and satisfy yourself there is no narcotics there, and I don't use narcotics.' So we went up to my room. I give him my full permission to go through the room. He also said, 'Well, if I don't find any narcotics I will know somebody is razzing me; I will have your word you are not a user of narcotics, and it is an awful gag and we will leave it go at that.' He went to my room and searched it, even took the light sockets off the fixtures and took everything apart, looked out in the hall, looked up in the cornices around the ceiling, and everything, and found absolutely nothing."

The witness testified further: During my conversation with Mr. McGuire, in my wife's presence, following our arrest, and upon being taken to the Commodore Hotel, I asked Mr. McGuire to make the charge against me, even though I was not found within sixty feet of the package. I made that request in an effort to have my wife spared the disgrace, embarrassment and humiliation of having to face this charge. Mr. McGuire informed me that

(Testimony of Lawrence William Brady.)

he was without authority or power to grant my request. He said that the District Supervisor was the only person who could act on my request. He informed me that he generally booked a per- [129] son immediately upon arresting him, but in this case he would take my wife and myself to the office of the District Supervisor, in the Narcotic Bureau, at 68 Post street. Later that evening Mr. Manning entered his office and I had a conversation with him. I did not tell Mr. Manning that I had bought the narcotics, U. S. Exhibit 1, in evidence, on Van Ness Avenue and paid \$300. I did not offer to turn in a source of supply of narcotics to Mr. Manning, because I have no source of supply. I wouldn't know where to turn to buy narcotics. I do not know any big shots. I do not know any narcotic peddlers. I do not know where I could get narcotics. That is what he said to me. He asked me why I was protecting these people and letting them rob me of my money. He is the one that termed the narcotics "flea powder." Agent McGuire was the one who suggested I paid \$300 for the narcotics, U. S. Exhibit No. 1 in evidence. They turned the whole thing around. Mr. McGuire and Mr. Manning completely turned the whole thing around. At that time I denied it just as emphatically as I denied it in the garage and in the room, and just as emphatically as I am denying it now. I never purchased narcotics. I didn't see narcotics. I never used any narcotics. I didn't know anything

(Testimony of Lawrence William Brady.)

about the package, and I don't know anything about it now. The first time I ever saw that package, U. S. Exhibit 1 in evidence, was when Mr. McGuire showed it to me in the garage after Grady had called up to where we were standing. The day after Mr. Cowan was arrested he got out of jail on bail, and he came to me and told me that Mr. McGuire thought that the stuff found in Cowan's possession was my stuff; he accused Cowan and said, "Why don't you tell me that this stuff belongs to—" me. He offered to let Cowan off light on the charge, or let him go, or make it easy for him if he would make the statement that the stuff found [130] on Cowan belonged to me and stated where the stuff came from.

When Cowan told me that I said, "I can understand McGuire saying that, because McGuire has already come up to my room once before, a long time ago, and searched my room thoroughly for narcotics; I can understand him saying that. I know he wants to get me; somebody has convinced him I am a user, and nobody in the world can convince him differently." I am not a user of narcotics. I do not use narcotics in any way, shape or form. I never have and I hope I never will. At the time Cowan worked for me I am positive he did not use narcotics. He was a good, capable businessman. He was a good manager. He never used narcotics. I hadn't seen him for months prior to this. He admitted, himself, it was only in the last few months that he had used narcotics prior to his

(Testimony of Lawrence William Brady.)

arrest. On the day that Cowan was arrested Mrs. Brady and I had an appointment to have dinner that evening with Mr. and Mrs. Cowan. That is how I happened to telephone to Cowan's room at the time Agent McGuire and Agent Grady were conducting a search of Cowan's room. Cowan had left word at my hotel for me to get in touch with him, which I did.

#### Cross Examination

I was married two years ago the 9th of this month. I purchased the Sphinx Club, in Reno, just after my wedding. I operated that club for a few months and then moved uptown to the Barn Club. I operated the Barn Club until I got into that mess in Reno that I have previously explained here. I then sold out to my partner, came down here, and joined the Merchant Marine. That was approximately November or December, 1942. From May 31, 1940 until May 31, 1942, I had operated the Continental Club in San Francisco. That was immediately before going to Reno, Nevada, and going into business there. On returning to San Fran- [131] cisco in the early part of 1943 I joined the Merchant Marine, sailing on February 9th for Guadalcanal. I left the ship at Honolulu on account of an injury, and returned to San Francisco, where I was hospitalized in the Marine Hopital. I was in the hospital until March 30, recuperating from a hernia operating. I stated that when I received the rupture I fell, and also noticed that my back hurt.

(Testimony of Lawrence William Brady.)

I felt that as soon as the hernia had been corrected I would be relieved of the backache, but I wasn't. The doctor told me not to do any heavy work for a while and give the rupture a chance to really heal and get back together so it wouldn't break open again while lifting or something. Since being discharged from the Marine Hospital I have received heat treatments from a doctor in the 450 Sutter Building, and around the first of this year I was confined to my bed for a few days suffering from the flu. I have also had some X-ray pictures of my back taken at the St. Francis Hospital. In 1925, when I was convicted of a felony I used the name of Bunker, which was an alias. The other difficulty I had in Reno in 1942 to which I pleaded nolo contendere was a Federal charge. After making the trip to Van Ness and Lombard street and letting my wife out of the car, and continuing on to Van Ness and Bay street, making a U-turn, picking up my wife at Van Ness and Lombard street and returning to the garage at 840 Sutter street, I would judge that it was approximately seven o'clock when we were in the garage. I would say it was quarter after seven or so when we reached the hotel room in company with the narcotics officers. We went from the hotel room to the office of the Narcotic Bureau. While waiting for Mr. Manning we went out and had something to eat and returned to the narcotics office again. Mr. Manning arrived around 11:00 or 11:30. At that time I had a discussion with Mr. Manning about this transaction. All I

(Testimony of Lawrence William Brady.)

had to say was that [132] I denied it all the way through. I denied having anything to do with the package; I denied any knowledge of the package. I denied it in the garage, I denied it in the hotel, I denied it in Manning's office, again in the restaurant, and back in Manning's office, in the outer office, and in the inner office with Mr. Manning. I explained to Mr. McGuire why we had driven out there to Van Ness and Lombard, that my wife wanted to see a vacant apartment, that I had dropped her at the corner and driven to Bay and Van Ness and back, picked her up, and drove to the garage. I explained I had nothing to do with the package, and knew nothing about it. I did not tell Mr. McGuire in the hotel room that I could lead him to some very big peddlers and dealers, and that I was willing to do that, provided Mrs. Brady and myself were not arrested and the car was released. When Mr. Manning told my wife, "You are the one that is on the spot, you are the one that is going to have to ride the beef for this thing"—those were his exact words—and when he said, "Unless you are half the man I think you are, Larry, you won't let this little girl do this for you." I said, "Yes, I am the one you have been after; I am the one you threatened and told other people you were going to get, and take my Cadillac car away, and put me in jail, you were going to get me regardless of how." Then I said, "Why should you take my little wife down and embarrass and shame and disgrace her?" I said, "I am the one you want, book the charge

(Testimony of Lawrence William Brady.)

against me. Let me ride the beef for her instead of, as you say, let her ride the beef for it." I did not mention anything about any peddlers; I didn't know any big narcotic peddlers. I have nothing to do with narcotics or peddlers. I do not know any addicts, with the exception of Cowan, who has admitted he is an addict to the Court. I do not associate with addicts. If people are addicts I will say I don't know it. If I know they are addicts I deliberately stay [133] away from them, because I don't care any more about narcotics or dope than the average other citizen does. I hate them just as bad, and I told that to Mr. Manning and to Mr. McGuire. The only reason we went to Mr. Mannings office was upon Mr. McGuire's suggestion that we get Mrs. Brady released. I at no time ever asked for an agreement or asked anything for myself. I was trying to keep my wife from being arrested and disgraced and humiliated, and that is merely the reason we went down to Mr. Manning's office in the first place. I am not a narcotic addict, nor have I ever been. With the exception of Mr. Cowan, I do not know any addicts. If I know anyone who is an addict, I don't know he is an addict.

I have never undergone treatment for the cure of the narcotic habit. On April 6th of this year I was admitted to the Patterson Sanitarium, in San Leandro under the name of W. L. Baldwin, for a nervous breakdown. My wife was admitted with me, under the name of Alice Baldwin. She had a

(Testimony of Lawrence William Brady.)

side ailment. We both went over there for a rest cure. If you will look at the books you will see it. We were both admitted for a nervous breakdown. That was right after the arrest, and I was so ashamed and so disgraced that I didn't even want to see myself. While my wife and I were in the Patterson Sanitarium, to my knowledge, we did not receive any narcotics administered to us. I entered that sanitarium on April 6th and left on April 11th. My wife was there from April 6th until April 16th. She had side trouble.

#### Redirect Examination

We entered the Patterson Sanitarium under the name of Baldwin simply because we were both so ashamed and disgraced over this narcotic charge. I didn't want to see my friends. I wanted to get away. My wife had a side trouble, I don't know just what it was, the doctor there didn't seem to know, but it was giving considerable [134] trouble. When we entered the hospital we signed as entering for a rest cure. That was a day or so after the arrest on this charge.

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#### TESTIMONY OF HESS MOSKOWITZ.

For the defendants.

Hess Moskowitz, produced as a witness on behalf of the defendants, having been first duly sworn, testified substantially as follows:

(Testimony of Hess Moskowitz.)

My name is Hess Moskowitz, and I am 28 years old. I am in the Merchant Marine. I have been introduced to Mr. Brady, and I recognize Mrs. Brady. I did not know either Mr. or Mrs. Brady on April 4th of this year. On that date I was passing the garage directly across the street from the Commodore Hotel at about 6:30 or 7:00 o'clock. I had a seven o'clock appointment just about a block and a half from there, on Sutter street. As I walked past the garage, the pictures of which you are showing me, marked Defendants' Exhibits D and C, I was just about to the entrance of the garage when a coupe pulled in front of me and pulled into the garage, and a man jumped out of the coupe and grabbed Mrs. Brady's arm.

Whereupon William H. Grady, an agent of the Federal Bureau of Narcotics and the witness who previously testified, entered the courtroom and was identified by the witness as the man whom he saw grab Mrs. Brady's arm.

The witness testified further: I think the car was still moving when Grady got out of the car. I did not notice anybody else get out of that car. Grady took Mrs. Brady's arm. As he took her arm, why, she pushed his hand away and then they just stood and talked. The reason I stood and watched was that I thought maybe it was a family affair. She had a purse in her arm, I thought maybe he was going to take the purse. I don't know [135] what made me stop; it was just one of those things. When I left there were other people standing

(Testimony of Hess Moskowitz.)

around the front of the garage. Before I left I noticed Grady and Mrs. Brady talking for a while, and then he reached over and picked up a package pretty close to where they were standing. The package was on the floor. I didn't see the package but it looked like a small package. I would say he picked it up four or five feet from where Mrs. Brady was standing. There were three men at the rear of the garage, which was quite a ways back, and Grady said in a loud voice when he picked up the package, I don't remember the exact words he said, it was something like, "I have got it," or "I have got her," something like that. Then these three men came forward to where Grady and Mrs. Brady were standing. That is when I first seen Mr. Brady; he was one of the three men who came forward. He had his hands up in the air. I started to leave, and as I walked from where I had been standing I heard one fellow, he was a pretty good sized fellow, say, "You are under arrest," or "I am placing you under arrest," something like that. Then I went on up the street. From the time I noticed Grady get out of the car and grab Mrs. Brady until I heard Grady shout to the men in the back, "I got it," or "I have it," and the men then started to come up, I would say it was about five minutes. I am here under subp<sup>e</sup>na. I have never seen you, Mr. Abrams, before today when I conversed with you outside the courtroom just before court convened this afternoon. I had a conver-

(Testimony of Hess Moskowitz.)

sation with Mr. Brady one day at the race track about coming here to testify. When he asked me to come I told him that I didn't know how long I would be in town, that I expected to ship out any day. That is all I heard about the matter until I had been subpeneaed.

#### Cross Examination

I am a Merchant Marine. My address now is 746 Geary [136] street. I have lived there about four months. Prior to that I lived at the Olympic Hotel in San Francisco approximately two months. I am originally from Omaha, Nebraska. I arrived in San Francisco during the month of December; that is, about six months ago. I have not made any trips in the Merchant Marine yet. I finished Merchant Marine School, and I have my papers. I am ready to ship out. I received my Merchant Marine schooling on a boat at a pier down here, Pier 28. I signed up right on that boat for the school. The school is run by a man by the name of Paul Stephans. There are three or four men on the boat who run the school. I am allowed to wear a uniform if I care to. I did not wear a uniform when I was going to school, and I did not live in a barracks. I lived at home. I attended school on the ship every day from eight in the morning until late in the afternoon, six days a week. I did not get paid. I received my shipping papers from the school, they call it Merchant Marine papers. I don't have my papers with me. I can go down and apply for a job as a sailor through the Union Hall.

(Testimony of Hess Moskowitz.)

I have already applied for a job on a ship. I expected to leave before now, but I expect that I will be gone within the next ten days. I attended this school for three and a half weeks. Before that my occupation was working in the fixture business, store and office fixtures. I finished the school about four months ago, after having attended the school three and a half weeks. I did not try to get a ship right away. I haven't been doing anything since I got out of school. In the latter part of the month of April I met Mr. Brady at the race track. I had not known him before. He was talking to a friend of mine at the race track. The friend's name is John Leal. After he talked to this friend of mine I asked this friend of mine if he knew Brady. He said he knew him. I told him that I had seen this fellow (Brady) being [137] arrested. I remembered I saw Mr. Brady being arrested, and I explained that to this friend. I was later introduced to Mr. Brady and he asked me to come here and testify what I saw of the transaction. I have only seen Mr. Brady twice before appearing here in the courtroom. The first time was when he was being arrested and the second time was that day at the race track when I was introduced to him by Mr. Leal. I have never met Mrs. Brady.

#### Redirect Examination

I do not have my seaman's papers with me but I do have a U. S. Coast Guard waterfront identification card with my fingerprints on it. Here it is.

(Testimony of Hess Moskowitz.)

Recross Examination

As I walked past the garage and saw the green coupe drive into the garage and saw Mr. Grady jump out of the car and grab Mrs. Brady's arm, that is all that I remember seeing right at the time. Later on I saw other people around the front of the garage, five or six people. At the time the car drove into the garage and Grady jumped out and grabbed the woman, Mrs. Brady, I did not see anybody in that vicinity other than Grady and Mrs. Brady. I do not know Mr. Cowan nor do I know a man by the name of Frenchy. I didn't see anybody there.

Further Redirect Examination

As I was walking up the street and got to the entrance of the garage as this coupe drove into the garage from which Grady got out, I did not see the car driving in preceding Grady's car; I didn't notice the car. [138]

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TESTIMONY OF MARGARET BRADY

One of the defendants.

Margaret Brady, one of the defendants, called as a witness in her own behalf, having been first duly sworn, testified substantially as follows:

My name is Margaret Brady. I am 33 years old. I am the wife of Lawrence William Brady, the other defendant in the case. I do not use narcotics; I have never used them. I have never handled

(Testimony of Margaret Brady.)

them or had anything to do with them. My husband does not use narcotics, or has he ever used them. I have never discussed narcotics with my husband outside of this instance when Mr. McGuire came to our room at the Sir Francis Drake Hotel and then when Mr. Cowan was arrested. Outside of those occasions I have never spoken to him about narcotics.

On April 4th of this year, around 6:00 o'clock in the evening, I was in my room at the Hotel Commodore, where my husband and I were living. My husband returned from the race track about 6:00 o'clock. I had been in the beauty parlor that afternoon and had heard there was an apartment to rent at Lombard and Van Ness, that there would be a vacaney there. When he came home from the race track I asked him to drive me over there, because we had been looking all over for an apartment for quite sometime. He said he had put the car away already, but that he would drive me out there. We left the hotel room, walked across the street to the garage, got in the car, and drove to Lombard and Van Ness. The catch on the hood of our car was broken, so that it kept rattling and jumping up and down. It did not interfere with the vision of my husband as he was driving the car. My husband looked through the rear view mirror on our car and saw this green coupe following us that we had seen on several occasions. He called my attention to it, so I turned around and I saw it. We both agreed that it must be the officers following

(Testimony of Margaret Brady.)

us because we had seen them several times since Mr. Cowan's arrest, the same [139] car following us. While I got out of the car at Van Ness and Lombard to look at the apartment, my husband drove further on out Van Ness Avenue, looking for a mechanic or someone who could fix the hood. He asked me to hurry, that he had promised to lend the car that evening to a friend of ours, and he wanted to get the car back to the garage. The place on the corner looked to be a private residence, it is a large white house there, so I decided that I either had got the wrong address or I had misunderstood the address, because it was no apartment house there. I stood there and waited for a few minutes. I did not go in. My husband returned in about five minutes and picked me up. We returned to the garage at 840 Sutter street. It must have taken us twenty-five or thirty minutes to make the round trip and back to the garage. As we got back into the garage I got out of the car and was going across the street to see if Mr. Cowan was there, and tell him that the car was available, that we were through with it for the evening. My husband said he would try to fix the catch, himself, on the hood of the car. As I was walking toward the front of the garage and I got just about to the first post inside the garage, pretty well toward the front of the door, I don't know how many feet it was, when this car swung around the corner, quite rapidly, and as it did the door opened, and I sort of stepped aside, stopped and stepped aside just a little. I just

(Testimony of Margaret Brady.)

stepped over a little for it to go by and Mr. Grady jumped out and grabbed ahold of my arm. I had a purse in it. He said, "Just a minute, we want to see you." I took this other hand and I was pushing his hand away, and I said, "Well, that isn't necessary," something like that. He let go of my arm. I did not pass the car. I just stepped over, and I think the car must have passed me, because I was standing still when he jumped out and grabbed me. The car rolled on toward the back [140] and Mr. McGuire and Mr. Ferguson went on and stopped in back of our car. Mr. Grady and I stood there for a few minutes. I looked toward the back; we both turned and looked toward the back of the garage where my husband and Mr. McGuire and Mr. Ferguson were standing. We couldn't see them because the two cars were in the way. In a few minutes, possibly about five minutes, Mr. Grady reached down and picked up this package off the floor. He said, "What's this?" I said, "I don't know." He said, "Is this yours?" I said, "No." "It doesn't belong to you?" I said, "No." He said, "You have never seen it before?" I said, "No." He then called to Mr. McGuire and he said, "It's here, Mac, I have it," something like that. The package must have been about three or four feet, three feet, anyway, away from where we were standing, because he had to take a little step, and then he reached over; so it would be about three feet. Looking toward the entrance of the garage,

(Testimony of Margaret Brady.)

it would be on the left side, and toward the grease rack. From the time Grady jumped out of the car, grabbed ahold of me, until he shouted back there, "I have it," it must have been five minutes, because we were both standing there looking toward the back where the other men were, and as I said, there were a few words exchanged, some conversation, so it was several minutes. I would estimate it at five minutes. I had never seen that package before he picked it up off the floor. It was not in our automobile. I do not know how it got on the floor. At that time I did not know where it came from. I did not see anybody around there throw it. In a few minutes, my husband, accompanied by Mr. McGuire and Mr. Ferguson, walked up to where Mr. Grady and I were standing. My husband had been handcuffed. Mr. McGuire was searching my husband. He took out his handkerchief, wrapped his money in the handkerchief, and replaced it in my [141] husband's pocket and said, "There is your money." Mr. McGuire questioned me about the package. I told him that it was not mine and I knew nothing about it. He questioned my husband about the package. My husband denied any knowledge whatsoever of the package. When Mr. Ferguson walked up to where we were standing I believe he said, referring to seeing the package being dropped, "I saw it, too." But evidently he couldn't have, because I couldn't see him from where I was. We then went across the street to our hotel room. When we were in the room there was quite a bit of

(Testimony of Margaret Brady.)

conversation. Agents Grady and Ferguson were searching the room and Mr. McGuire was talking to my husband and I. He said:

"‘Well, there is no use of both of you going down on this.’ He said, ‘There is no evidence against Larry, he wasn’t within sixty feet of it.’ He said, ‘You, little lady,’ or something like that, ‘are the one that is on the spot; you were standing closest to where the package was found.’ So he turned to my husband and he said, ‘If you are half the man I think you are,’ he said, ‘You are not going to let this little girl,’ his words, ‘ride the beef for you.’ And my husband said, ‘I am certainly not, and I am the one you want, the one you have been after, been telling everyone you are going to get, so arrest me and take me down and book it against me and let my wife go, because she has not been down there, she doesn’t know what it is about.’

Mr. McGuire said he was in favor of that, too, but that he didn’t have the authority to do that without Mr. Manning’s consent \* \* \*”

The witness testified further: I never told Mr. McGuire or Mr. Manning, or anybody else, that I knew that package was [142] in the car, or that I carried the package from the car to the hotel, or dropped it there. Those were the words used by Major Manning in his office. When we were in Major Manning’s office those were his words:

“He said, ‘Where did you get the package? Did you pick it up off the car seat to carry it across to

(Testimony of Margaret Brady.)

your hotel?' I said, 'I did not.' He made the remark then, 'Why did you drop it, it was pretty hot stuff to handle. Was it burning your hands,' something like that, and I told him again that I didn't have it, but he went over that several times trying to get me to say—he said that Larry, there was no evidence against him, he was not found near the spot, I was the one that was in the tough spot, that it was found closest to me; trying to make me say that I had picked it up off of the car seat to carry it across to the hotel, but I told him I hadn't seen it. Then the last thing he said to me before I went out of his office, he said, 'Well, try and use your influence on Larry, he respects your judgment, try to get him to work with us, it will be much easier on both of you. We can help you out that way.' Well, I told him I didn't know any names. I knew that my husband didn't. We would be glad to help them if there was anything that we could do, any names we could give them, but they have turned the conversation around to mean that when up in the room my husband wanted the evidence booked against him, and me released, they have turned it around so as to say that he admitted it was his, but he only asked to have me released and have it booked against him. He did not admit that it was his. So that was the only reason we went to Major Manning's office, was to see if they would arrest him and place the [143] charges against him and let him come up in court and settle it and let me go.

(Testimony of Margaret Brady.)

Q. Anything said about the car, letting the car go?

A. Yes. He said, 'Let me wife have the car and go on about her business and just arrest me, and hold me, and we will go up in court and settle it there.' "

#### Cross-Examination

I deny that I threw that package on the floor of the garage on the day in question. I never had that package in my possession. I deny that I picked it up from the seat of my husband's automobile and when I saw the agents threw it to the floor. I deny that I ever had any conversation with Major Manning in which I admitted that I picked it up from the seat of the automobile and that when I saw the agents I threw the package to the floor. In the conversation with Mr. McGuire in the hotel room my husband did not say to Mr. McGuire that he bought these narcotics for \$300 from a man some place over in the vicinity of Van Ness and Lombard; my husband did not say that he wanted to make a deal in which the automobile would be released and no charges would be filed. He said he wanted to talk to Major Manning, and see if they would book the charges against him and release me. It is not a fact that my husband admitted to Major Manning that he had purchased the narcotics for \$300. It is not a fact that I admitted that I had picked up the package from the seat of the automobile and was going to carry it to the hotel, and when I saw the agents threw it to the ground.

(Testimony of Margaret Brady.)

It is not a fact that my husband's proposition was that if Major Manning would forget about this thing and not arrest us and return our car that we would work with the Narcotic Bureau and turn in some of the big peddlers in San Francisco. In my conversation with Major Manning he told me that if I could use [144] my influence with my husband to get him to give them some names, he says, "At the trial we can reach over to the judge and whisper that you folks are working for us, and it will go much easier with you," or something like that. I did not hear him say anything about mentioning that fact to the United States Attorney, who would then in open court tell the judge that we had been of assistance to the Government. I am not a narcotic addict, nor have I ever been a narcotic addict, nor have I ever received treatment for addiction to narcotics. I was admitted to the Patterson Sanitarium in San Leandro on the 6th day of April of this year under the name of Alice Baldwin, and remained there until the 16th of April, but I was not admitted to the sanitarium for the purpose of being treated for drug addiction. I was a nervous wreck and I was admitted for a rest cure, and while there I developed female trouble, and the doctor treated me for that.

#### Redirect Examination

I was in the Patterson Sanitarium from the 6th to the 16th. The doctor kept me off my feet for two weeks.

Whereupon the defendants rested.

## TESTIMONY OF FRANCIS KEARNEY

For the United States. In Rebuttal.

Francis Kearney, produced as a witness on behalf of the United States in rebuttal, having been first duly sworn, testified substantially as follows:

My name is Francis K. Kearney. I am a licensed physician and surgeon in the State of California. My office is at 930 A street, Hayward, California. I was licensed to practice in [145] 1933. I have been practicing continuously since that time. I attended University of California Medical School and graduated from there in 1933. I follow a general practice. In the course of my practice I have occasion to treat patients at the Patterson Sanitarium in San Leandro. In my capacity as a physician and surgeon I am familiar with the diagnosis of drug addiction, and also with the treatment for drug addiction. On the 6th day of April of this year I was called to the Patterson Sanitarium to treat a Mr. and Mrs. Baldwin, whom I see in the courtroom here today.

Whereupon the witness identified Lawrence W. Brady and Margaret Brady as the Mr. and Mrs. Baldwin to whom he referred.

"**Mr. Davis:** May the record show that the witness has identified the defendants on trial?

"**The Court:** The record may so show."

The witness testified further: At the time I treated them on or about the 6th day of April I diagnosed their cases as narcotic addiction. I prescribed a treatment that we have for narcotic ad-

(Testimony of Francis Kearney.)  
diction which consists of the injection or administering or narcotics over a period of time with a gradually-diminishing dose. That is the treatment I prescribed for Mr. and Mrs. Brady, whom I knew as Mr. and Mrs. Baldwin.

#### Cross-Examination

I know what they were admitted to the hospital for, but I do not have any record with me.

"Mr. Abrams: Have you a record of it, Mr. Davis?

"Mr. Davis: I may have. I have another witness from the hospital who should have the record.

Mr. Abrams: May I see the record?

Mr. Davis: Well, when we put the other witness on. Maybe I have some records here, if you will allow me to reopen, and I can ask to put these records in.

Q. Doctor, as a matter of fact, do you know that it is a [146] State law that when you prescribe narcotics it is necessary for you to file with the Division of Narcotics Enforcement a record of the fact that you are treating an addict and you have prescribed certain treatment? A. I do.

Mr. Abrams: I am going to object to those.

Mr. Davis: You asked for those records.

Mr. Abrams: No. I mean—

Mr. Davis: Q. Doctor, I will ask you if this is your signature appearing on these three cards?

A. Yes.

Q. I will ask you if those are the records which,

(Testimony of Francis Kearney.)

under the law, you are required to send to the Division of Narcotics Enforcement of the State of California when you have prescribed treatment for a narcotic addict and have administered narcotics?

A. They are.

Q. I will ask if these are the cards? I will read them to you. The first one reads, 'Report to Division of Narcotic Enforcement, 156 State Building, Civic Center, San Francisco, Cal.'

Mr. Abrams: Just a moment. I object to this, your Honor. I object to these. They are cards obviously sent by the doctor to the Division of State Narcotics. They are the records of the State Narcotic Division.

The Court: You asked for the record.

Mr. Abrams: I did not ask for the record. I asked for the record on their admittance to the hospital.

Mr. Davis: These records are records which are required by law to be kept by any doctor prescribing narcotics. Under the State law, he must give the name and address of the person, the diagnosis of the ailment, the amount of dosage that he has given, and the quantity and kind of narcotic. Those must be forwarded to the State Division of [147] Narcotics.

The Court: Objection overruled.

Mr. Abrams: Exception.

The Court: Proceed.

Mr. Davis: Q. Doctor, I will ask you in this case if this is the card which you furnished to the

(Testimony of Francis Kearney.)

State Enforcement Division, the State Narcotic Division, and I will read it to you:

'Report to Division of Narcotic Enforcement, 156 State Building, Civic Center, San Francisco, Cal.

Name of Patient W. L. Baldwin Age 39  
Address 1440-16th Avenue San Leandro'

That is the address of—

A. The address of the Sanitarium, yes.

Mr. Davis (continues reading):

'Quantity and kind of narcotic Heroin  
Daily dosage M. S. gr IV 1st day of cutting daily'

Will you explain, Doctor, what that means?

A. That is the drug that was used in the treatment, morphine sulphate, grains one-quarter. Does it say grains 1?

Q. It says 'Grains'—

A. 'Grains 4.'

Q. 4 grains.

A. 4 grains the first day, cutting daily.

Mr. Davis (continuing reading):

'Diagnosis of injury or ailment Addict  
Has patient previously used narcotics?

A. Yes. Addicted? Yes.

Physician's name F. K. Kearney, M. D.

Address 930 A. St. Hayward, Calif.

Date of Report April 7, 1944

Federal Registration No. 4503.'

(Testimony of Francis Kearney.)

Is this the record which you kept, or made out for Mr. [148] Baldwin, at the time he was admitted and that you filed with the State Bureau of Narcotics?

A. That is.

Mr. Davis: At this time I offer this card in evidence as Government's Exhibit next in order.

Mr. Abrams: I object to that as incompetent, irrelevant, and immaterial, and not binding on the defendants.

The Court: Overruled.

(The document was marked U. S. Exhibit 2 in evidence.)

Mr. Davis: I will read the second card here.

'Report to Division of Narcotic Enforcement 156 State Building. Civic Center, San Francisco, Cal.

Name of patient Alice Baldwin Age 34

Address 1440-168th Avenue, San Leandro

Quantity and kind of narcotic Heroin

Daily Dosage M.S. gr IV 1st day cutting daily

Diagnosis of injury or ailment Addict

Has patient previously used narcotics? Yes.

Addicted? Yes.

Physician's signature, F. K. Kearney, M. D.

Addrses 930 A. Street, Hayward, Calif.

Date of Report April 7, 1944

Federal Registration No. 4503.'

I will ask you if that is the card which you forwarded to the State Bureau of Narcotics Enforce-

(Testimony of Francis Kearney.)

ment for Alice Baldwin at the time you treated her? A. Yes.

Mr. Davis: If the Court please, at this time I offer in evidence this card as Government's Exhibit next in order.

Mr. Abrams: Same objection.

Mr. Davis: Q. You have identified Mr. and Mrs. Baldwin as being Mr. and Mrs. Brady?

The Witness: Yes. [149]

The Court: What is the answer?

The Witness: A. Yes.

The Court: Objection overruled. Let it be admitted and marked.

Mr. Abrams: Exception.

(The document was marked U. S. Exhibit 3 in evidence.)

Mr. Davis: Q. This final card reads:

'Daily dosage Patient unco-operative left Sanitarium

Diagnosis of injury or ailment Addict

Has patient previously used narcotics? Yes.

Addicted? Yes.

Physician's signature, F. K. Kearney, M. D.

Address 930 'A' Street, Haywood, Calif.

Date of report 4/13/44

Fed. Reg. No. 4503.'

Q. I will ask you if this is the card which you furnished to the Bureau of Narcotic Enforcement when Mr. Baldwin left the hospital?

A. Yes, it is.

(Testimony of Francis Kearney.)

Mr. Davis: At this time I offer this card in evidence.

Mr. Abrams: Same objection.

The Court: Overruled.

Mr. Abrams: Exception.

(The document was marked U. S. Exhibit 4 in evidence.)

Mr. Davis: That is all.

Mr. Abrams: I still ask for the record of the entrance to the institution.

Mr. Davis: In the first place, the doctor is not associated with the institution; he hasn't any record. I told you when I put the next witness on if she has the record you can see it. He is not competent to put in records of the hospital. [150]

"Mr. Abrams: That's right.

Q. Doctor, you are not connected with the hospital there? A. Not directly.

Q. You practice a great deal at that hospital?

A. I have patients there most of the time.

Q. Where is your office? A. In Hayward.

Q. Hayward? A. Yes.

Q. Is that hospital a general hospital having patients of all types?

A. No; I think it could be classed as a convalescent rest home.

Q. And handles mental cases and cases of that type. Did you examine both of these persons?

A. Yes, I did.

Q. Physical examination?

(Testimony of Francis Kearney.)

A. Well, I gave them an examination on the first day that I saw them.

Q. What did your examination consist of?

A. Blood pressure, heart and lungs, urine tests were taken.

Q. Does the hospital have admittance sheets or admittance records?

A. They have an admittance slip, I think, with the patient's name and address.

Q. Showing what they came there for?

A. No; there is no diagnosis in the admittance slip, I don't think.

Q. It doesn't show the patient's complaint?

A. I don't believe it does.

Q. Do you recall in this particular case whether it did or did not, the case of these two people?

A. No, I don't.

The Court: The answer is he doesn't know."

The witness testified further: I was contacted by these people, as I recall, before they came into the hospital to make an examination of them. Either they or their friends called me. I never saw them until I saw them in the sanitarium; they were not my patients before. [151]

"Q. On this card it says, 'Diagnosis of injury or ailment Addict.' What did you base your opinion on?

A. On the patients' admissions that they were addicts, and that is what they came there for treatment.

(Testimony of Francis Kearney.)

Q. They told you that?

A. They told me that?

Q. Both of them told you they were addicts?

A. Yes.

Q. They told you that?

A. Yes, they were both addicts, and had been taking heroin for some time.

Q. They told you that?

A. Yes. They were particularly specific, said they had been taking heroin for sometime intravenously.

Q. What do you mean intravenously?

A. In the veins.

Q. Where did they tell you they were taking it at, what part of their body?

A. In their arms, mostly.

Q. Did you examine their arms to see—

A. Yes.

Q. Whether they were taking it?

A. Yes.

Q. Did you find marks of that?

A. Yes.

Q. You did? A. Yes.

Q. You found punctures?

A. Evidence of puncture wounds, evidence of sclerosis of the veins, obliteration of some of the veins.

Q. Showing injections?

A. Over a period of time.

Q. Were they fresh or new or old?

A. I don't think one could say.

Q. What is your opinion?

(Testimony of Francis Kearney.)

A. My opinion would be that some were old and some were perhaps very recent.

Q. Clearly noticeable?

A. Noticeable to me, yes.

Q. Could they be noted by anybody, by the jurors looking at it? A. Yes, I am sure.

Q. They could see it? A. Yes. [152]

Q. Could you tell they were addicted to narcotics in any other way than their telling you?

A. Yes.

Q. And finding these marks on their arms?

A. Yes, I could.

Q. Did you? A. Yes.

Q. How.

A. By their clinical records during their stay in the hospital.

Q. That showed it? A. Yes.

Q. How long were they in the hospital?

A. Mrs. Baldwin stayed for, I think somewhere around two weeks, and Mr. Baldwin less than a week.

Q. You say you prescribed medicine containing heroin for their treatment?

A. No, I did not say that. It says right on the card, there, the treatment, morphine sulphate. Heroin is not available to the medical profession.

Q. It says that here.

A. Heroin is not available to the medical profession in this case.

Q. You said you prescribed morphine.

A. Sulphate.

(Testimony of Francis Kearney.)

Q. It says that here?

A. I used the abbreviation 'M.S.'

Q. You used the abbreviation 'M.S.' What is morphine sulphate?

A. It is an alkaloid of opium.

Q. You prescribed that daily?

A. I believe at first.

Q. You believe at first. How is the nervous state in the addict manifested?

A. The thing typical of the average narcotic addict is they usually come in very calm and collected, but as the drug is withdrawn from them they naturally develop nervous symptoms, characterized by insomnia or inability to sleep.

Q. Were they calm and collected when you first examined them? A. I would say so.

Q. They weren't in a rather nervous state?

A. No. [153]

Q. Did you find anything else wrong with Mrs. Baldwin, or treat her for anything?

A. She complained of abdominal pain for a few days, but it was just previous to her menstrual period and it seemed to clear up after that.

Q. Let me ask you, Doctor: You are familiar with the cure of persons addicted to narcotics?

A. I think you better say treatment.

Q. The practice of curing.

A. I doubt if I ever have cured them.

Q. What is the length of time normally for a course of treatment?

(Testimony of Francis Kearney.)

A. According to Lambert's treatment, that is probably the accepted treatment in this country, two weeks for a treatment.

Q. Two weeks. Isn't it usually at least twenty days or more?

A. At least it must work in two weeks. I am speaking of actual treatment. The withdrawal symptoms should be pretty well gone in two weeks, according to the Lambert treatment.

Q. As a matter of fact, when anyone addicted to narcotics gets into an institution for any kind of a cure they are required to stay at least twenty days or more, aren't they?

A. I don't think there is any requirement whatsoever.

Q. Isn't that the usual thing? Is it? You can't do much in less than twenty days, can you?

A. It depends entirely on the individual.

Q. You do the work in two weeks?

A. I have dismissed any number in two weeks with a complete absence of any withdrawal symptoms. That is not a cure, as you well know.

Q. You have discharged them in two weeks?

A. I have, and they were entirely free of any withdrawal symptoms.

Q. Have you known of other doctors not discharging them for [154] at least twenty days or more?

A. I believe you could find other degrees of treatment.

(Testimony of Francis Kearney.)

The Court: What do you mean by 'withdrawal symptoms'?

A. The typical symptom that an addict gets when he does not get his drug.

Mr. Abrams: Q. Doctor, did you see Mr. and Mrs. Baldwin the first day they arrived there?

A. I don't believe I did. I don't recall whether it was the second or third day.

Q. As a matter of fact, it was either the second or third day after they got there that you saw them?

A. I may have seen them the first; I don't recall exactly. Lots of times I don't see the patients the day they arrive; I am just too busy, that is all.

Q. Do your records indicate the first time you saw them?

A. I believe there is a note in the record when I first visited them.

Q. You have your records?

A. No; I mean the records in the sanitarium.

Q. Will these cards indicate at all the first time you saw them? A. I don't believe they do.

Q. They do not? A. I don't know.

Mr. Davis: Well, show them to the doctor.

The Witness: Let me see them. I don't believe there is any indication. No; it is just the date of the report. We are given a few days leeway on that.

Mr. Abrams: That is all. [155]

## TESTIMONY OF ELLEN JONES

For the United States. In Rebuttal.

Ellen Jones, produced as a witness on behalf of the United States in rebuttal, having been first duly sworn, testified substantially as follows:

My name is Ellen Jones. I am a trained nurse employed at the Patterson Sanitarium in San Leandro. On the 6th day of April 1944, I know of my own knowledge that two patients by the name of Mr. and Mrs. Baldwin were admitted to the Patterson Sanitarium. I see them here in the courtroom today.

"Q. Will you point them out to us, please?

A. Yes (indicating).

Mr. Davis: May the record show that the witness has identified the defendants?

The Court: The record will so show."

The witness testified further: I am superintendent of nurses, at the Patterson Sanitarium, and in such capacity supervise the medication or treatment prescribed by the doctors. Mr. and Mrs. Baldwin were being treated for drug addiction. I know that the treatment prescribed for them was for drug addiction. I administered some of the treatment myself to both Mr. and Mrs. Baldwin. It consisted of injections of morphine. I have with me some of the records of the hospital showing the admission of these patients.

"Q. I will show you this card, Miss Jones, and ask you to tell us what this card is, in the records of the sanitarium.

(Testimony of Ellen Jones.)

A. That is an admittance card.

Q. As a matter of custom in the sanitarium, is it the practice to make out an admittance card for each patient who is admitted? A. Yes.

Q. This is the admission card for Mr. W. L. Baldwin? A. That's right. [156]

Mr. Davis: I will read it (reading):

'Name Baldwin W. L. Mr.

Address 874 Pine St San Francisco

Physician Dr. Kearney

Date admitted April 6th Thus—6 p.m.

Date Discharged

Bldg. Main Room

Rate 50.00

Sanitarium care arranged by Self

Address 874 Pine St., San Francisco

In Emergency Phone Ord—3444

I hereby assume all financial responsibility for  
sanitarium care: L. W. Baldwin

Address Same.'

Q. This is the record, the admission card, is it not? A. It is.

Q. Did you also examine the record card of Mrs. Baldwin? A. Yes.

Q. Is there anything on Mrs. Baldwin's card other than what appears on this?

A. No, it is the same.

Q. Is it the custom or practice at the sanitarium at any time to write the diagnosis of the disease or malady for which the patients are being treated upon this record card? A. No.

(Testimony of Ellen Jones.)

Mr. Abrams: I object to that as incompetent, irrelevant, and immaterial. We are not concerned with custom. We want to know what was done in this particular case.

Mr. Davis: Q. Well, in this particular case did you write— A. No.

Q. (continuing) —the diagnosis?

Mr. Abrams: The card speaks for itself. [157]

Mr. Davis: Q. Is it the custom to write that on there?

Mr. Abrams: Just a moment.

The Witness: A. No.

Mr. Abrams: Just a moment, lady. Will you give me a chance to make an objection?

The Court: State your objection.

Mr. Abrams: I object to it on the ground it is incompetent, irrelevant, and immaterial, calling for an opinion and conclusion of the witness, asking for a custom.

Mr. Davis: I am entitled to show that this particular card is the admission card of the patient, and find out what the custom is, if it is the custom to put any such diagnosis on the card.

The Court: Overruled.

Mr. Abrams: Exception.

Mr. Davis: I offer this card in evidence.

The Court: Admitted.

(The document was marked U. S. Exhibit 5 in evidence.)

Mr. Davis: Q. Miss Jones, in your capacity as superintendent of nurses, you have custody of

(Testimony of Ellen Jones.)

the records at the Patterson Sanitarium relative to the treatment given to patients? A. Yes.

Q. I show you these two documents and ask you if those are the records kept in the regular course of business. A. Yes.

Q. At the sanitarium, covering the medication and treatment of patients admitted? A. Yes.

Q. Are those—is one of those the record of Mr. Baldwin and the other of Mrs. Baldwin?

A. Yes.

Q. This is a history of their treatment each day?

A. Yes.

Q. That they were in the hospital?

A. Yes, sir.

Q. In other words, this is what a layman calls the chart? [158] A. Yes.

Q. The nurse's record and the chart that is kept? A. Yes.

Mr. Davis: At this time I offer both of these records of Mr. and Mrs. Baldwin in evidence, as Government's Exhibit next in order.

Mr. Abrams: Objected to as incompetent, irrelevant, and immaterial.

The Court: Overruled.

(The charts were marked U. S. Exhibits 6 and 7 in evidence.)

Mr. Abrams: Exception."

#### Cross-Examination

"Mr. Abrams: Q. I just want to ask you what is quarter grain M.S.; is that quarter grain morphine sulphate solution?

(Testimony of Ellen Jones.)

A. Quarter grain of morphine sulphate, yes.

Q. Quarter grain tablet?

A. That's right."

Redirect Examination

"Mr. Davis: Q. I just want to ask you one question: You are familiar with the manner in which prescriptions are written, are you not?

A. Yes.

Q. Would you say that on this card where it says 'M.S. gr' and in Roman numerals the figure 'I' and 'V', does that indicate  $\frac{1}{4}$  grain, or 4 grains?

A. That would be 4 grains in twenty-four hours, giving one grain at 8, 12, 4 and 8."

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TESTIMONY OF THOMAS E. McGUIRE

a witness previously sworn, called for the United States in rebuttal:

I heard Mr. Cowan testify in this case to certain conversations which he had with me. In those conversations I did not tell Mr. Cowan that I wanted him to come to the Federal Court [159] and testify before the grand jury that the narcotics that he had purchased and which he had in his possession at the time he was arrested had been purchased for Mr. Brady. The only interest I had in Mr. Cowan testifying was to testify against the man whom Mr. Cowan had purchased the narcotics from. That man was known *was known* to me, and the only in-

(Testimony of Thomas E. McGuire.)

terest I had in Mr. Cowan's testifying at the time was to testify against the person from whom Mr. Cowan had purchased the narcotics. On the 4th day of April of this year I arrived outside of the Commodore Hotel in the afternoon and was there from approximately one o'clock on. While observing the Commodore Hotel I saw Mr. Cowan leave the hotel somewhere around three o'clock in the afternoon. We followed him, and he went to a gambling house located at Eddy and Mason Street, I believe. It is known as the Day and Night gambling house. I returned to my position outside the Commodore Hotel and remained there until Mr. and Mrs. Brady left in their car to go out to Van Ness Avenue and Lombard Street. Up to that time I had not seen Mr. Cowan return to the hotel.

#### Cross-Examination

I am not sure that the Day and Night gambling house is at Eddy and Mason. It could be Turk and Mason. It is diagonally across the street from the Columbia Hotel.

Whereupon the Government rested its case on rebuttal.

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**TESTIMONY OF LAWRENCE W. BRADY,**  
one of the defendants previously sworn, called in his own behalf in surrebuttal:

"Mr. Abrams: Q. Mr. Brady, will you remove your coat and pull your sleeve up, your shirt sleeve? A. Yes.

(Testimony of Lawrence W. Brady.)

Q. On both arms. A. Yes. [160]

Q. Display them to the jury.

(The witness displayed his bare arms to the jury.)

Mr. Abrams: Put your coat back on. That is all.

Mr. Davis: That is all."

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TESTIMONY OF MARGARET BRADY,  
one of the defendants, previously sworn, called in  
her own behalf in surrebuttal.

"Mr. Abrams: Q. Mrs. Brady, take your coat  
off. A. All right.

(The witness displayed her bare arms to  
the jury.)

Mr. Abrams: Q. Now, put it on. Just sit up  
there a minute."

The witness testified further: I was in that hospital for three or four days before the doctor came to see me. I had developed a pain in my side, and the lady there called some doctor. We never called a doctor of any kind.

TESTIMONY OF MARGARET BRADY,  
one of the defendants, previously sworn, recalled  
in her own behalf in surrebuttal.

I asked the doctor to give me medicine for the pain in my side, and did not ask him for anything else. I told him that I had a very bad pain. In fact, the nurse thought it possibly could be appendicitis. That was why she called the doctor then. The doctor did not tell me what he was giving me in the way of medicine or medical treatment. I never told the doctor that I was an addict or had been using heroin; neither did my husband, because we were both in the same room. [161]

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TESTIMONY OF LAWRENCE W. BRADY,  
one of the defendants, previously sworn, recalled in  
his own behalf in surrebuttal.

I was in the hospital approximately three days before the doctor came. I did not send for the doctor, and I don't know who did. I never saw the man before he showed up that night. I never asked the doctor for anything but a sleeping pill, which he gave me and which I took with water, and he gave me another brown pill and treated me for nerves. I never asked him for anything. I never knew what I was getting in the way of medicine and nobody explained it to me. Different nurses gave me the medicine. I saw the doctor only the one time he came to examine my wife. I never told the doctor

(Testimony of Lawrence W. Brady.)

that my wife and I were addicted to drugs. He was not sent for for that. He was sent for to relieve my wife of excruciating pain in her side. If he administered any drugs he did it of his own accord. When I entered the hospital I did not tell them that I was an addict or that I was there for addiction treatment. I told them that my wife had an extremely bad case of nerves, and I also had bad nerves. It was emphatically understood that I was to leave as soon as my wife was better. I stayed three or four days.

#### Cross-Examination

I did not receive any injection by the use of a hypodermic needle intravenously while in the sanitarium. I received an injection in the shoulder once or twice, but I don't know what it was for.

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Mr. Abrams: Your Honor, I omitted something. Pardon the interruption. I meant at the close of the case, your Honor, to ask your Honor to strike from the record all testimony of the witnesses concerning this hospitalization of the defendants at [162] the Patterson Sanitarium, as being irrelevant matter, wholly unconnected with the issues of this case, and not binding upon the defendants.

The Court: Motion will be denied.

Mr. Abrams: Exception.

Whereupon the defendants rested their case in surrebuttal.

Whereupon the case was argued to the jury by counsel for the United States and for the Defendants.

Thereafter, the arguments having been concluded, the Court [163] instructed the jury.

Thereafter, the instructions to the jury having been concluded, the case was submitted to the jury, and thereafter the jury returned into court and rendered a verdict finding the defendants and each of them guilty on each of the two counts in the indictment.

Thereafter counsel for the defendants moved the Court in arrest of judgment, which motion in arrest of judgment is as follows:

“[Title of Court and Cause.]

MOTION OF LAWRENCE W. BRADY AND  
MARGARET BRADY IN ARREST OF  
JUDGMENT

Come now the defendants Lawrence W. Brady and Margaret Brady in the above entitled action, and against whom a verdict of guilty was rendered on the 8th day of June, 1944, in the above entitled cause, and move the Court to arrest the judgment against said defendants and hold for naught the verdict of guilty rendered against said defendants upon each and every count, for the following causes:

1. That the verdict is contrary to the evidence adduced at the trial herein.
2. That the verdict is not supported by the evidence in the case.
3. That the evidence adduced at the trial is insufficient to justify said verdict.
4. That said verdict is contrary to law.
5. That the trial court erred in admitting evidence in the course of the trial where no proper foundation had been laid.
6. That the trial court erred in admitting evidence in the course of the trial which was hearsay.
7. That the trial court erred in denying defendants' petition made in writing to quash arrests and for dismissal [164] on all the grounds urged in said written petition which was filed on April 29, 1944.
8. That the trial court erred in admitting in evidence during the course of the trial a package which contained the narcotics described in the indictment, which was taken by the Federal narcotic agents unlawfully and in violation of defendants' Constitutional rights under the Fourth and Fifth Amendments of the Constitution of the United States.
9. That the trial court erred in permitting testimony to be given during the course of the trial concerning the package containing the narcotics mentioned in the preceding paragraph, said seizure being in violation of defendants' Constitutional rights under the Fourth and Fifth Amendments of the Constitution of the United States.

10. That the trial court erred in overruling defendants' repeated objections made during the course of the trial to the admission of such evidence referred to in paragraph 8 and testimony in connection therewith.

11. That the trial court erred in denying defendants' motion made at the close of the case to strike out all testimony of witnesses concerning the hospitalization of defendants in a sanitarium and their examination and treatment there.

12. That the trial court erred in admitting in evidence certain records made by the witness Dr. Francis Kearney entitled 'Report to Division of Narcotic Enforcement' and all testimony in connection therewith, and in refusing to strike the same from the record.

13. That the trial court erred in admitting in evidence testimony of witnesses, including Dr. Francis Kearney and Ellen Jones concerning the hospitalization of defendants in [165] a sanitarium and their examination and treatment there, and a certain admission card of W. L. Baldwin to said sanitarium and hospital records entitled 'Doctor's Orders' in the cases of W. L. Baldwin and Mrs. Baldwin.

14. That the trial court erred in denying defendants' motion, made at the close of plaintiff's case, for a directed verdict of acquittal on both counts of the indictment, for the reason that the legal evidence as a matter of law was insufficient to support a verdict of guilty.

Wherefore, because of which said errors in the record hereof, no lawful judgment may be rendered by the Court, said defendants pray that this motion be sustained and that judgment of conviction against them be arrested and held for naught and that they have all such other orders as may seem meet and just in the premises.

This written motion is by leave of Court and supplements the oral motion heretofore made by said defendants, and is made upon the minutes of the Court, upon all records and proceedings in said action, and upon all the testimony and evidence introduced at the trial herein.

Dated: June 10, 1944.

SOL A. ABRAMS

Attorney for Defendants".

Which said motion in arrest of judgment was by the Court denied, to the denial of which the defendants duly and regularly excepted.

Thereafter counsel for the defendants moved the Court for a new trial, which motion for a new trial was as follows:

"[Title of Court and Cause.]

#### MOTION FOR A NEW TRIAL

Now come the defendants Lawrence W. Brady and Margaret Brady in the above entitled action and move this Honorable [166] Court for an order vacating the verdict of the jury convicting said defendants, and granting said defendants a new

trial on both counts of the indictment for the following, and each of the following causes materially affecting their Constitutional rights, to wit:

1. That the verdict is contrary to the evidence adduced at the trial herein.
2. That the verdict is not supported by the evidence in the case.
3. That the evidence adduced at the trial is insufficient to justify said verdict.
4. That said verdict is contrary to law.
5. That the trial court erred in admitting evidence in the course of the trial where no proper foundation had been laid.
6. That the trial court erred in admitting evidence in the course of the trial which was hearsay.
7. That the trial court erred in denying defendants' petition made in writing to quash arrests and for dismissal on all the grounds urged in said written petition which was filed on April 29, 1944.
8. That the trial court erred in admitting in evidence during the course of the trial a package which contained the narcotics described in the indictment, which was taken by the Federal narcotic agents unlawfully and in violation of defendants' Constitutional rights under the Fourth and Fifth Amendments of the Constitution of the United States.
9. That the trial court erred in permitting testimony to be given during the course of the trial concerning the package containing the narcotics mentioned in the preceding paragraph, said seiz-

ure being in violation of defendants' [167] Constitutional rights under the Fourth and Fifth Amendments of the Constitution of the United States.

10. That the trial court erred in overruling defendants' repeated objections made during the course of the trial to the admission of such evidence referred to in paragraph 8 and testimony in connection therewith.

11. That the trial court erred in denying defendants' motion made at the close of the case to strike out all testimony of witnesses concerning the hospitalization of defendants in a sanitarium and their examination and treatment there.

12. That the trial court erred in admitting in evidence certain records made by the witness Dr. Francis Kearney entitled 'Report to Division of Narcotic Enforcement' and all testimony in connection therewith, and in refusing to strike the same from the record.

13. That the trial court erred in admitting in evidence testimony of witnesses, including Dr. Francis Kearney and Ellen Jones concerning the hospitalization of defendants in a sanitarium and their examination and treatment there, and a certain admission card of W. L. Baldwin to said sanitarium and hospital records entitled 'Doctor's Orders' in the cases of W. L. Baldwin and Mrs. Baldwin.

14. That the trial court erred in denying defendants' motion made at the close of plaintiff's case, for a directed verdict of acquittal on both counts of the indictment, for the reason that the

legal evidence as a matter of law was insufficient to support a verdict of guilty.

To all of which rulings these defendants duly and regularly excepted.

This written motion, by leave of Court, supplements the [168] oral motion heretofore made by said defendants, and is made upon the minutes of the Court, upon all records and proceedings in said action, and upon all the testimony and evidence introduced at the trial herein.

Dated: June 10, 1944.

S. A. ABRAMS

Attorney for defendants."

Which said motion for a new trial was by the Court denied, to the denial of which the defendants duly and regularly excepted.

The said motions in arrest of judgment and for a new trial having been denied, the Court proceeded to pass judgment upon the defendants, and thereafter, and on June 10, 1944, the Court imposed judgment and sentence upon the defendant Lawrence William Brady as follows: That defendant Lawrence William Brady on Count One of Indictment No. 28520-R serve a term of three years in a United States Penitentiary, to be designated by the Attorney General of the United States, and pay a fine of \$1000.00; that defendant Lawrence William Brady on Count Two of Indictment No. 28520-R serve a term of three years in a United States Penitentiary, to be designated by the Attorney General of the United States, and pay a fine

of \$1000.00; the judgments on Count One and Count Two of Indictment No. 28520-R to run consecutively.

The above bill of exceptions contains all of the evidence, oral and documentary, and all of the proceedings relating to the trial, conviction, motion in arrest of judgment, motion for a new trial, and judgment and sentence.

Dated: San Francisco, California, July 5, 1944.

SOL A. ABRAMS

Attorney for Appellant.

Lodged July 5, 1944.

[Endorsed]: Filed Aug. 15, 1944. C. W. Calbreath, Clerk. [169]

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[Title of District Court and Cause.]

## ORDER SETTLING BILL OF EXCEPTIONS

Pursuant to stipulation of counsel, it is hereby ordered that that certain document of one hundred twenty-seven pages, lodged with the Clerk of this Court on July 5, 1944, entitled Bill of Exceptions, of the defendant Lawrence W. Brady may be and the same is hereby considered to truthfully set forth the proceedings had upon the trial of the defendant Lawrence W. Brady and that it contains in narrative form all of the testimony taken upon the trial together with all of the objections made by said defendant and the rulings thereon and the exceptions noted by said de-

fendant and it may be and is hereby settled, allowed, certified and approved as the Bill of Exceptions in the above entitled matter;

And it is further ordered that the Clerk of said Court file the same as a record in said case and transmit it to the Honorable Circuit Court of Appeals for the Ninth Circuit.

Dated: August 15, 1944.

MICHAEL J. ROCHE.

United States District Judge.

[Endorsed]: Filed Aug. 15, 1944. C. W. Calbreath, Clerk. [170]

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District Court of the United States  
Northern District of California

**CERTIFICATE OF CLERK TO TRANSCRIPT  
OF RECORD ON APPEAL**

I, C. W. Calbreath, Clerk of the District Court of the United States, for the Northern District of California, do hereby certify that the foregoing 170 pages, numbered from 1 to 170, inclusive, contain a full, true, and correct transcript of the records and proceedings in the case of The United States of America, vs. Lawrence W. Brady, No. 28520 R, as the same now remain on file and of record in my office.

I further certify that the cost of preparing and certifying the foregoing transcript of record on appeal is the sum of \$9.80 and that the said amount

has been paid to me by the Attorney for the appellant herein.

In Witness Whereof, I have hereunto set my hand and affixed the seal of said District Court at San Francisco, California, this 22nd day of August. A. D. 1944.

[Seal]

C. W. CALBREATH,

Clerk

M. E. VAN BUREN

Deputy Clerk [171]

---

[Endorsed]: No. 10809. United States Circuit Court of Appeals for the Ninth Circuit. Lawrence W. Brady, Appellant. vs. United States of America, Appellee. Transcript of Record. Upon Appeal from the District Court of the United States for the Northern District of California, Southern Division.

Filed August 24, 1944.

PAUL P. O'BRIEN

Clerk of the United States Circuit Court of Appeals for the Ninth Circuit.

At a Stated Term, to wit: The October Term 1943, of the United States Circuit Court of Appeals for the Ninth Circuit, held in the Court Room thereof, in the City and County of San Francisco, in the State of California, on Monday the seventeenth day of July in the year of our Lord one thousand nine hundred and forty-four.

Present:

Honorable Francis A. Garrecht, Circuit Judge,  
Presiding,

Honorable William Healy, Circuit Judge.

No. 10809

LAWRENCE W. BRADY,  
Appellant,  
vs.

UNITED STATES OF AMERICA,  
Appellee.

**ORDER ADMITTING APPELLANT  
TO BAIL**

Upon consideration of the motion of appellant for admission to bail pending appeal, and good cause therefor appearing, It Is Ordered that such motion be, and hereby is granted, and that appellant be admitted to bail pending appeal upon the giving of a bail bond in amount of Five thousand dollars (\$5,000.00) conditioned as required by law, the bond to be approved by the United States Attorney for the Northern District of California,—

if personal sureties the sureties to justify before the United States Commissioner for said District —and by a Judge of this Court, and to be filed with the clerk of this Court.

---

In the United States Circuit Court of Appeals  
for the Ninth Circuit

No. 10809

LAWRENCE W. BRADY,

Appellant,

vs.

UNITED STATES OF AMERICA,

Appellee.

BAIL BOND ON APPEAL

Know All Men By These Presents:

That we, Lawrence W. Brady, of the City and County of San Francisco, State of California, as principal, and the National Automobile Insurance Company, a California corporation, as surety, are jointly and severally held firmly bound unto the United States of America in the sum of Five Thousand (\$5,000.00) Dollars, for the payment of which sum we, and each of us, bind ourselves, our heirs, executors and assigns.

The condition of the foregoing obligation is as follows:

Whereas, lately, to-wit, on the 10th day of June, 1944, at a term of the United States District Court

in and for the Northern District of California, Southern Division, in an action in said court numbered 28520-R, in which the United States of America was plaintiff and Lawrence W. Brady was defendant, judgment and sentence was made, given, rendered and entered against the said Lawrence W. Brady in said action, whereas he was convicted as charged in the indictment in said action.

Whereas, in said judgment and sentence so made, given, rendered and entered against said Lawrence W. Brady in said action, he was sentenced by said judgment to imprisonment and fines as follows: Three years imprisonment and a fine of \$1000 on first count; three years imprisonment and a fine of \$1000 on second count, sentences to run consecutively.

Whereas, the said Lawrence W. Brady has filed a Notice of Appeal from said conviction and from said judgment and sentence appealing to the United States Circuit Court for the Ninth Circuit; and

Whereas, the said Lawrence W. Brady has been admitted to bail pending the decision upon said appeal in the sum of Five Thousand (\$5,000.00) Dollars by order of the United States Circuit Court of Appeals for the Ninth Circuit made and entered on the 17th day of July, 1944, in the above entitled matter;

Now, Therefore, the conditions of this obligation are such that if said Lawrence W. Brady shall appear in person, or by his attorney, in the United States Circuit Court of Appeals for the Ninth Cir-

cuit on such day or days as may be appointed for the hearing of said cause in said Court and shall prosecute his appeal, and if said Lawrence W. Brady shall abide by and obey all orders made by said United States Circuit Court of Appeals for the Ninth Circuit, and if said Lawrence W. Brady shall surrender himself in execuation of such judgment and sentence if the judgment and sentence be affirmed by the United States Court of Appeals for the Ninth Circuit, and if said Lawrence W. Brady will appear for trial in the District Court of the United States in and for the Northern District of California, Southern Division, on such day or days as may be appointed for the re-trial by said District Court if the said judgment and sentence against him be reversed, then this obligation shall be null and void; otherwise to remain in full force and effect.

This recognizance shall be deemed and construed to contain the "express agreement", summary judgment and execution thereon mentioned in Rule 34 of the District Court.

LAWRENCE W. BRADY,  
Principal.

I certify that this is the signature of the principal herein.

[Seal] STUART H. ELLIOTT,  
U. S. Commissioner, Western District of Wash.,  
Southern Div.

[Seal] NATIONAL AUTOMOBILE  
INSURANCE CO.,  
a California corporation,  
By B. WATSON,  
Attorney-in-Fact.

I hereby certify that I have examined the above bond and that, in my opinion, the form thereof is correct and the surety thereon is qualified.

SOL A. ABRAMS,  
Attorney for Defendant and  
Appellant.

The foregoing bond is approved this 5th day of August, 1944.

FRANK J. HENNESSY,  
United States Attorney.  
By I. Q. CADERS,  
Assistant United States At-  
torney.

The foregoing bond is approved this 11th day of August, 1944.

WILLIAM HEALY,  
Judge of the United States Circuit Court of Ap-  
peals, Ninth Circuit.

This power of attorney is hereby attached to and made a part of Bond No. 30440, Lawrence W. Brady, Appellant.

Certified Copy

**POWER OF ATTORNEY**

National Automobile Insurance Company  
Know All Men By These Presents:

That the National Automobile Insurance Company, a corporation organized and existing under the laws of the State of California, and having its principal office in the City of Los Angeles, California, does hereby constitute and appoint B. Watson of the City of San Francisco, State of California, its true and lawful Attorney-in-Fact, to execute, seal and deliver for and on its behalf as Surety any and all bonds and undertakings not exceeding in penalty the sum of Ten Thousand and No/100 Dollars (\$10,000.00) each, which are or may be allowed, required, or permitted by law, statute, rule, regulation, contract, or otherwise. And when such bonds or undertakings shall have been duly executed pursuant hereto and the corporate seal affixed they shall be as binding upon said Company, as fully and amply, to all intents and purposes, as if they had been duly executed and acknowledged by the duly elected officers of the Company at its Principal Office.

In Testimony Whereof, the National Automobile Insurance Company has caused this instrument to be signed and its corporate seal to be affixed by its officers this 9th day of October, 1942.

[Seal]            NATIONAL AUTOMOBILE  
                  INSURANCE COMPANY,  
By JOHN Q. McCLURE,  
                  President  
By O. W. MOORE,  
                  Secretary

State of California  
County of Los Angeles—ss.

On this 9th day of October, 1942, before me, M. T. Logan, a Notary Public in and for said County and State, residing therein, duly commissioned and sworn, personally appeared John Q. McClure and O. W. Moore to say that they are respectively the President and Secretary of the National Automobile Insurance Company, a corporation, and that the seal affixed to the foregoing instrument is the corporate seal of said corporation and that the said instrument was signed and sealed on behalf of said corporation by authority of its Board of Directors, and said John Q. McClure and O. W. Moore acknowledge said instrument to be the voluntary act and deed of said corporation.

In Witness Whereof, I have hereto set my hand and affixed my official seal the day and year first above written.

[Seal]

M. T. LOGAN,

Notary Public in and for said  
County and State.

My Commission Expires Jan. 8, 1946.

State of California,

City and County of San Francisco—ss

On this 4th day of August, in the year 1944, before me, George B. Gillin, a Notary Public in and for said County and State, personally appeared B. Watson, known to me to be the person whose name is subscribed to the within instrument as the Attorney-in-fact of the National Automobile Insurance Company, and acknowledged to me that he subscribed the name of the National Automobile Insurance Company thereto as principal, and his own name as Attorney-in-fact.

[Seal]

GEORGE B. GILLIN,

Notary Public in and for said  
County and State.

My Commission Expires December 24, 1946.

State of Washington

County of Pierce—ss

I, W. J. Haniger, a duly authorized officer, having the power and authority to administer oaths in said cause do hereby certify that on this, the 10th day of August, 1944, personally appeared before me Lawrence W. Brady, to me known to be the individual described in and executed the foregoing

bond, and acknowledged that he signed and sealed the same as his free and voluntary act for the uses and purposes therein mentioned.

In Witness Whereof, I have hereto set my hand in the day and year this signature first above was written.

W. J. HANIGER,  
Acting Warden.

Authorized to administer oaths by the Act (Public No. 426) approved February 11, 1938.

Approved by me this 10th day of August, 1944.

[Seal] STUART H. ELLIOTT,  
U. S. Commissioner for the Western District of Washington, Southern Division.

United States of America,  
Western District of Washington,  
Southern Division—ss:

CERTIFICATE

I, Judson W. Shorett, Clerk of the United States District Court for the Western District of Washington, do hereby certify that Stuart H. Elliott, whose name is subscribed to the foregoing instrument, is, and was at the time of subscribing the same, United States Commissioner for the Western District of Washington, at Tacoma, duly appointed, qualified and commissioned, and that full faith and credit are due to all his official acts as such.

In Witness Whereof, I have hereunto set my hand  
and official seal of said Court, at Tacoma, Wash-  
ington, this 10th day of August, 1944.

[Seal]            JUDSON W. SHORETT,  
                          Clerk,  
By E. E. REDMAYNE,  
                          Deputy.

[Endorsed]: Filed Aug. 11, 1944. Paul P.  
O'Brien, Clerk.

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[Title of Circuit Court of Appeals and Cause.]

**STATEMENT OF POINTS RELIED ON AND  
DESIGNATION OF PARTS OF TRAN-  
SCRIPT TO BE PRINTED**

Comes now Lawrence W. Brady, the appellant  
herein, and advises the Court that he intends to rely  
on the following points in his appeal:

All points specified as errors in the Assignment  
of Errors, Notice of Appeal, and memorandum en-  
titled "Additional Grounds on Notice of Appeal",  
heretofore filed and appearing in the transcript of  
record and by reference incorporated herein.

DESIGNATION OF PARTS OF TRANSCRIPT  
TO BE PRINTED

In support of appellant's position, appellant believes it necessary to print the entire record.

Dated: September 1, 1944.

SOL A. ABRAMS,

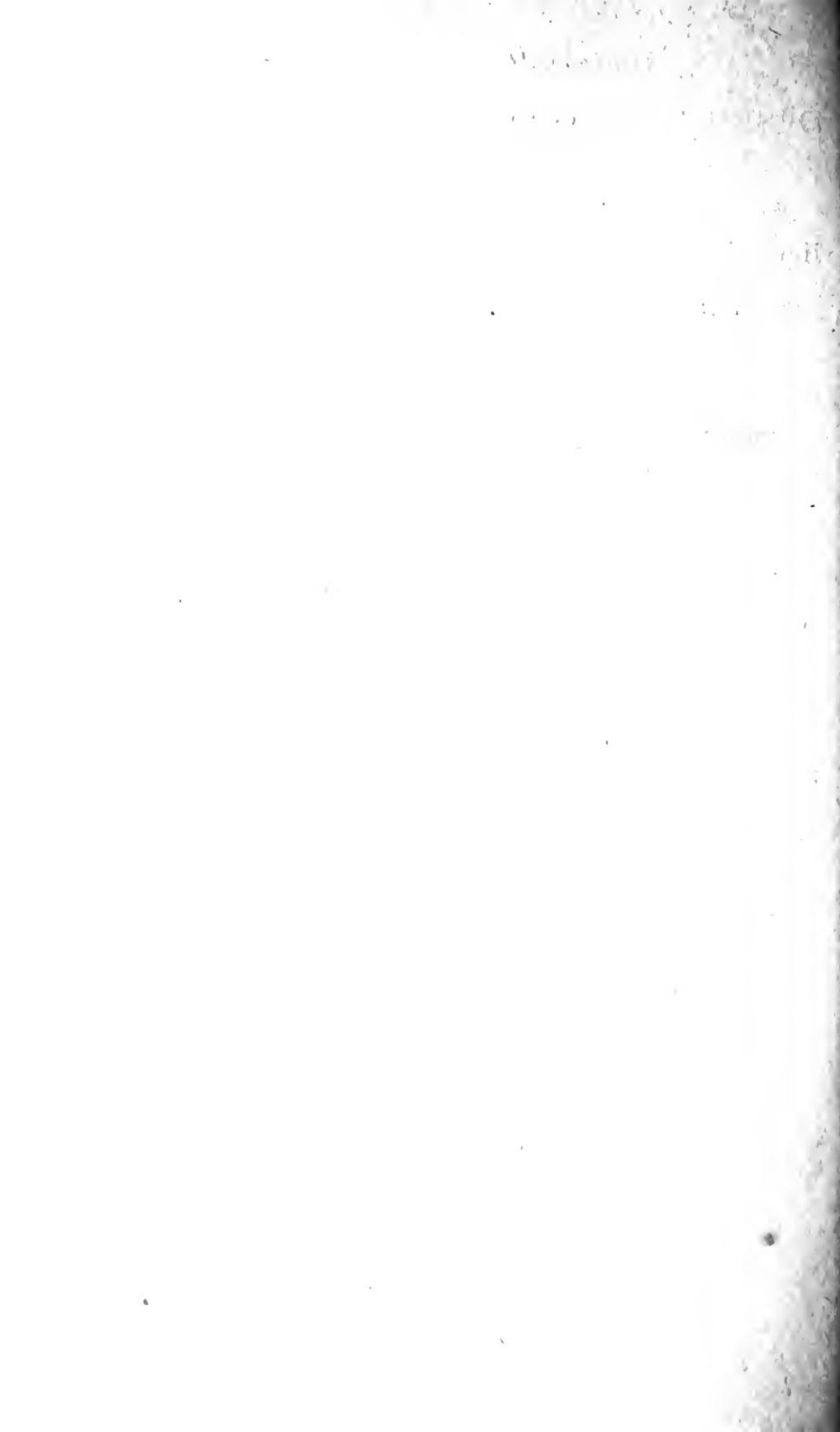
Attorney for Appellant.

Receipt of copy of within statement is hereby acknowledged this 1st day of September, 1944.

FRANK J. HENNESSY,

United States Atty.

[Endorsed]: Filed Sept. 1, 1944. Paul P.  
O'Brien, Clerk.



No. 10,809

United States  
Circuit Court of Appeals  
For the Ninth Circuit

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LAWRENCE W. BRADY,

*Appellant,*

vs.

UNITED STATES OF AMERICA,

*Appellee.*

BRIEF FOR APPELLANT

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FILED

NOV - 8 1944

SOL A. ABRAMS,

PAUL P. O'BRIEN  
CLE

Kohl Building,  
San Francisco, Calif.,

*Attorney for Appellant.*



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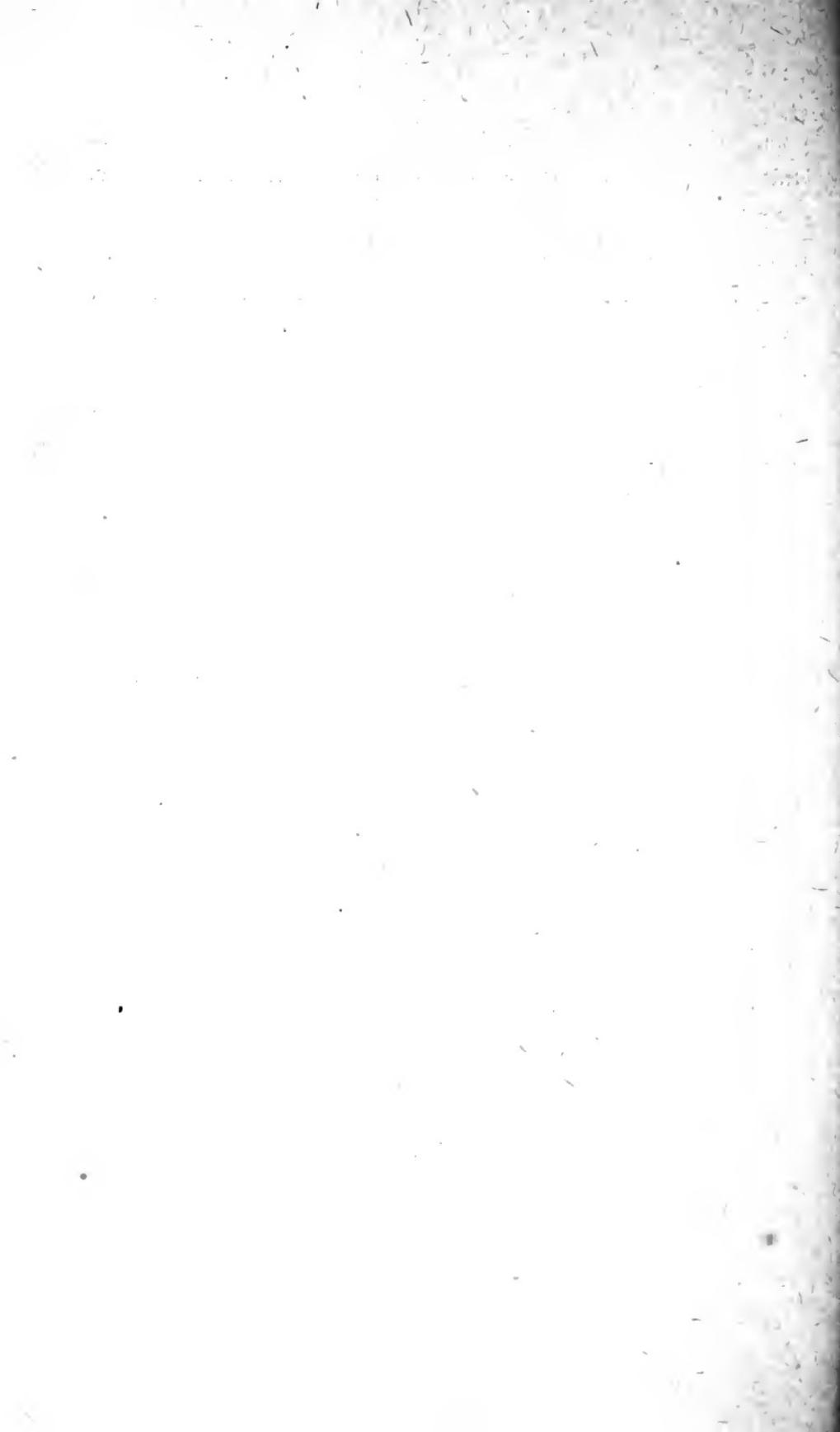
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United States  
Circuit Court of Appeals  
For the Ninth Circuit

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LAWRENCE W. BRADY,

*Appellant,*

vs.

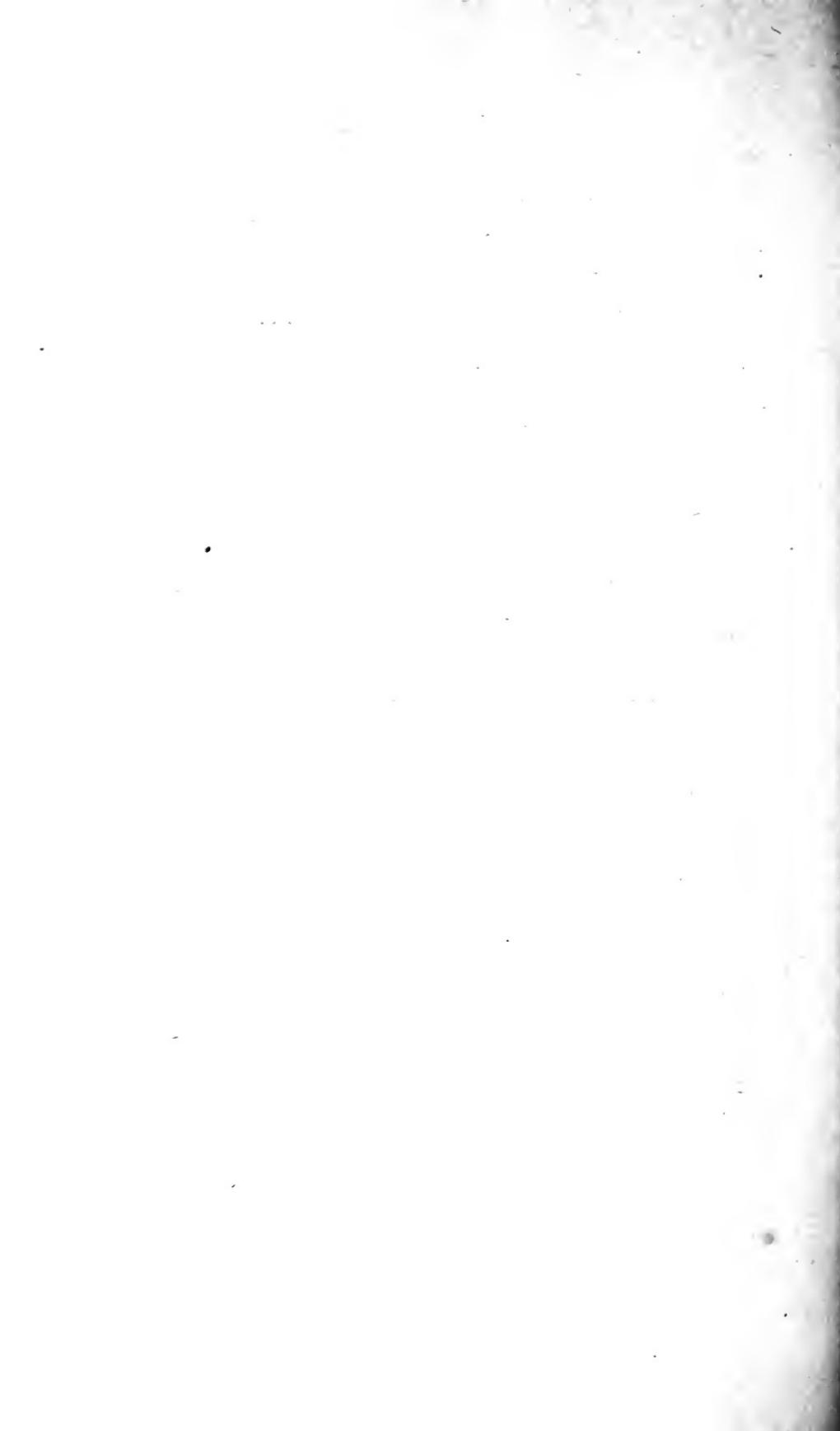
UNITED STATES OF AMERICA,

*Appellee.*

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JURISDICTIONAL STATEMENT

This is an appeal from a judgment of conviction by the Southern Division of the United States District Court for the Northern District of California. The offenses charged in the indictment are violations of the Jones-Miller Act, 21 U.S.C. 174 and are punishable by imprisonment for a term exceeding one year. This Court has jurisdiction under the provisions of 28 United States Code, Section 225, subdivision (a), First and Third and subdivision (d).



United States  
Circuit Court of Appeals  
For the Ninth Circuit

---

LAWRENCE W. BRADY,

*Appellant,*

vs.

UNITED STATES OF AMERICA,

*Appellee.*

---

BRIEF FOR APPELLANT

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OFFENSES CHARGED, PLEA AND OUTCOME

Appellant was charged in an indictment, jointly with his wife Margaret Brady, in two counts with violations of the Jones-Miller Act, to wit, the unlawful concealment and transportation of narcotics, namely, heroin (T.R. 2). Two trials by jury were had; the first trial ended in a disagreement (T.R. 11); upon the second trial appellant and his wife were found guilty on both counts of the indictment (T.R. 17). After motions in arrest of judgment and for new trial were denied (T.R. 18) appellant was sen-

tenced to imprisonment for a term of three years and to pay a fine of \$1000 on each count, the sentences to run consecutively (T.R. 19), whereupon appellant filed his notice of appeal (T.R. 22); the other defendant, appellant's wife, has not appealed, but is presently serving a sentence imposed by the Court. By order of this Court appellant was admitted to bail pending appeal (T.R. 193), said bond having been posted (T.R. 194).

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### THE FACTS

Briefly, the facts of the case are:

Agents of the Federal Bureau of Narcotics, having known appellant and his wife prior to April 4, 1944, on said date about six o'clock in the evening observed appellant drive his Cadillac automobile into a public garage at 840 Sutter Street, San Francisco. Appellant immediately left the garage and entered the Commodore Hotel across the street where he resided, and in about fifteen minutes came out of the hotel with his wife, re-entered the garage and drove out in his automobile. The agents followed appellant to Van Ness Avenue and Lombard Street where Mrs. Brady left the car and remained standing on the street corner for about five minutes while appellant was seen to drive several blocks further down Van Ness and return to pick up his wife and drive back to the same public garage on Sutter Street. As the agents drove into the garage behind appellant, Mrs. Brady got out of appellant's car and started to walk out of the garage. As she passed the agents' automobile, a small package was seen

to drop to the floor of the garage, apparently from the folds of her clothing. When first seen by the agents the package was in the process of falling (T.R. 39-41; 66-68).

The agent did not see the package in Mrs. Brady's hands, but could only see a package dropping towards the floor of the garage from the side of her clothing. He picked up the package from a position of between four and six inches from her feet (T.R. 54). He did not know what was in the package until he opened it and examined its contents (T.R. 62).

While one agent was picking up the package and placing Mrs. Brady under arrest, the other two agents in the automobile went to the rear of the garage and placed appellant under arrest (T.R. 68). When the first agent apprehending Mrs. Brady picked up the package, he shouted to the other two agents in the rear of the garage: "I have it" (T.R. 62 and T.R. 68). Both appellant and Mrs. Brady denied knowledge of the narcotics (T.R. 68). Appellant was then taken to his room in the Commodore Hotel across the street, the room was searched by the agents and appellant was also searched. However the agents did not find any narcotics on appellant's person, in his room or among his possessions (T.R. 69). The agents testified to conversations had both in appellant's hotel room immediately after his arrest (T.R. 70), and in the office of the District Supervisor several hours later in the evening (T.R. 71-72) wherein appellant is alleged to have admitted the purchase of the narcotics picked up in the garage and having paid \$300 for the same.

Both appellant and his wife testified. Appellant claimed that he drove out to Van Ness Avenue and Lombard

Street with his wife so she could look at an apartment. Dropping her off at the corner he went on a few blocks to find a place to have the hood of his car fixed (T.R. 132-134). When he returned to the garage appellant was in the act of attempting to fix the hood himself when the agents stepped up and placed him under arrest (T.R. 134-135; 80-81). Appellant was handcuffed (T.R. 136). Appellant denied admitting ownership and purchase of the narcotics (T.R. 139).

Irving Cowan, produced as a witness by appellant, testified that he observed someone other than appellant and appellant's wife throw the package into the garage from a position on the runway to the basement and flee (T.R. 123-124).

In rebuttal witnesses, a doctor (T.R. 161) and a nurse (T.R. 174), produced by the prosecution, testified that appellant and his wife were hospitalized in a sanitarium shortly following their arrest; their ailments were diagnosed as drug addiction and they were given treatment for the same.

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#### **STATEMENT OF POINTS RELIED ON**

Appellant raises four main points as alleged errors as follows:

##### **1. Insufficiency of the evidence to sustain the verdict.**

(Paragraphs numbered 1, 2, 3 and 4, Assignment of Errors (T.R. 30); paragraph numbered 14, Assignment of Errors (T.R. 32).)

**2. The arrest and subsequent seizure were illegal.**

(Paragraphs numbered 7, 8, 9 and 10, Assignment of Errors (T.R. 31).)

**3. The trial court erred in admitting documentary and oral evidence concerning the hospitalization and treatment of appellant and his wife.**

(Paragraphs numbered 11, 12, 13 and 16, Assignment of Errors (T.R. 31-33).)

**4. The trial court erred in admitting in evidence the extra-judicial admissions and statements of appellant and his wife.**

(Paragraph numbered 15, Assignment of Errors (T.R. 32).)

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**ARGUMENT**

**FIRST POINT RAISED: INSUFFICIENCY OF THE EVIDENCE  
TO SUSTAIN THE VERDICT**

That the verdict is contrary to the evidence adduced at the trial herein (Paragraph 1, Assignment of Errors, T.R. 30).

That the verdict is not supported by the evidence in the case (Paragraph 2, Assignment of Errors, T.R. 30).

That the evidence adduced at the trial is insufficient to justify said verdict (Paragraph 3, Assignment of Errors, T.R. 30).

That said verdict is contrary to law (Paragraph 4, Assignment of Errors, T.R. 30).

That the Court erred in denying defendant's motion made at the close of plaintiff's case, for a directed verdict of acquittal on both counts of the indictment, for the reason that the legal evidence as a matter of law was insufficient to support a verdict of guilty (Paragraph 14, Assignment of Errors, T.R. 32).

The facts do not connect appellant with the alleged offense; it was not shown by the evidence that appellant possessed or transported or had knowledge of the package or its contents allegedly found by the agents on the floor of the garage. At the time the agents claimed they observed the package dropping at the feet of Mrs. Brady, Mrs. Brady was near the entrance of the garage on her way out and appellant was at the rear of the garage fixing the hood of his automobile. At no time was appellant seen in possession of or near the package. No evidence was offered from which knowledge of the package or its contents can be imputed to appellant.

There must be an intentional participation in the transaction with a view to the common design and purpose before a party can be guilty of crime.

*Nuennemacher v. U. S.*, 27 Fed. Cas. No. 15902;  
*U. S. v. Lancaster*, 44 Fed. 896;  
*U. S. v. Newton*, 52 Fed. 275.

Guilty knowledge is a necessary element of proof which is lacking here.

*Pettibone v. U. S.*, 148 U.S. 197;  
*Ezzard v. U. S.*, 7 Fed.(2) 808;  
*People v. Long*, 7 Cal. App. 27;

case turned on failure of proof E. was  
 wholesale dealer - generally not at all

*People v. Kennedy*, 21 Cal. App.(2) 185;  
*People v. Zoffel*, 35 Cal. App.(2) 215;  
*People v. Rodriguez*, 37 Cal. App.(2) 290;  
*People v. Tom Woo*, 181 Cal. 315.

It must be shown that the defendant had knowledge of and participated in the alleged unlawful act. Circumstances merely arousing suspicion of guilt are insufficient. Knowledge of the unlawfulness of the act must also be shown. A verdict that finds its only support in conjecture or speculation cannot stand.

*Tingle v. U. S.*, 38 Fed.(2) 573;  
*Reavis v. U. S.*, 93 Fed(2) 307;  
*Ching Wan et al. v. U. S.*, 35 Fed.(2) 665;  
*Kassin v. U. S.*, 87 Fed.(2) 183;  
*Eng Jung v. U. S.*, 46 Fed.(2) 66;  
*Weniger v. U. S.*, 47 Fed.(2) 692 (C.C.A. 9th Cir.);  
*Rossi v. U. S.*, 49 Fed.(2) 1 (C.C.A. 9th Cir.);  
*Qwong Mow v. U. S.*, 13 Fed.(2) 121;  
*Nosowitz v. U. S.*, 282 Fed. 575;  
*U. S. v. DeVito*, 68 Fed.(2) 837;  
*Grant v. U. S.*, 49 Fed.(2) 118;  
*U. S. v. Buchalter*, 88 Fed.(2) 625, 626;  
*Henderson v. Commonwealth*, 107 S.E. 700, 701;  
*Alexander v. State*, 221 Pac. 516;  
*Ezzard v. U. S.*, supra;  
*Karchner v. U. S.*, 61 Fed.(2) 623;  
*Girgenti v. U. S.*, 81 Fed.(2) 741, 742;  
*People v. Tom Woo*, supra;  
*People v. Rodriguez*, supra;  
*State v. Lund*, 18 P.(2) 603;

*State v. McWilliams*, 57 P.(2) 788;  
*State v. Wallette*, 75 P.(2) 799;  
*Richards v. State*, 6 P.(2) 449;  
*Barr v. State*, 231 Pac. 322.

In *Ezzard v. U. S.*, supra, where the defendant was arrested and charged with possession of narcotics when a trunk he was transporting in his automobile was found to contain narcotics, the Court held that the evidence failed to show the defendant had knowledge of the contents of the trunk.

To sustain a conviction, it should appear not only that the offense was committed, but the evidence inculpating the defendant should do so to a degree of certainty transcending mere probability or strong suspicion.

*Simpson v. City*, 93 P.(2) 539;  
*Wheeler v. State*, 94 P.(2) 9;  
*Bristow v. State*, 94 P.(2) 254;  
*Dowell v. State*, 94 P.(2) 956;  
*People v. Stanford*, 100 P.(2) 796;  
*Starr v. State*, 74 P.(2) 1174;  
*Saferite v. State*, 93 P.(2) 762;  
*Young v. U. S.*, 48 Fed.(2) 26;  
*Patterson v. U. S.*, 222 Fed. 599.

Likewise, the mere presence of appellant at or near the scene of crime is not of itself sufficient to sustain a conviction.

*Girgenti v. U. S.*, supra;  
*U. S. v. DeVito*, supra;  
*Graceffo v. U. S.*, 46 Fed.(2) 852;

*State v. Hood*, 298 Pac. 354;  
*Barr v. State*, supra;  
*U. S. v. Johnson et al.*, 26 Fed. 682;  
*Nosowitz v. U. S.*, supra;  
*Rivera v. U. S.*, 57 Fed.(2) 816.

Even knowledge of the commission of an illegal act is insufficient to warrant conviction. Neither knowledge on the part of a defendant of the commission of an illegal act or a passive acquiescence therein or failure to denounce it will justify a conviction.

*Rudner v. U. S.*, 281 Fed. 251.

The general rule is that possession, to be incriminating, must be personal and exclusive.

*Willsman v. U. S.*, 286 Fed. 852, 855.

So far as the record shows appellant never had possession of the package, nor was it ever shown to be under his control. It follows then that the statutory rule holding that when the defendant is shown to have or to have had possession of a narcotic drug, such possession shall be deemed sufficient evidence to authorize conviction unless the defendant explains the possession to the satisfaction of the jury, may not be invoked to sustain the verdict against him.

*Willsman v. U. S.*, supra, page 854.

In the case of *Henderson v. Commonwealth*, supra, the court clearly defines possession. We quote briefly:

“In 3 Greenleaf’s Evidence, Sec. 33, the author says:

'But to raise the presumption of guilt from the possession of the fruits of (or) the instruments of crime by the prisoner, it is necessary that they be found in his exclusive possession. A constructive possession, like constructive notice or knowledge, though sufficient to create a civil liability, is not sufficient to hold the prisoner to a criminal charge. He can only be required to account for the possession of things which he actually and knowingly possessed, as, for example, where they are found upon his person, or in his private apartment, or in a place of which he kept the key. If they are found upon premises owned or occupied as well by others as himself, or in a place to which others had equal facility and right of access, there seems no good reason why he, rather than they, should be charged upon this evidence alone.' "

The record fails to show that the narcotics in question were in the immediate and exclusive possession of appellant and under his dominion and control.

*People v. Sinclair*, 129 Cal. App. 320;  
*People v. Herbert*, 59 Cal. App. 158.

The evidence of facts are as consistent with innocence as with guilt, in the case of appellant, and is insufficient therefore to sustain the conviction.

"Unless there is substantial evidence of facts which exclude every hypothesis but that of guilt, it is the duty of the trial court to instruct the jury to return a verdict for the accused; and where all the substantial evidence is as consistent with innocence as with guilt, it is the duty of the Appellate Court to reverse a judgment of conviction."

*Willsman v. U. S.*, supra, page 856.

See, also,

- 6
- Tingle v. U. S.*, supra;
- Peightel v. U. S.*, 49 Fed.(2) 235, 240;
- Ezzard v. U. S.*, supra, page 812;
- Cox v. U. S.*, 96 Fed.(2) 41, 43;
- Paddock v. U. S.*, 79 Fed.(2) 872;
- Spalitto v. U. S.*, 39 Fed.(2) 782.

Possession of the instruments or fruits of crime by a defendant, in order to be incriminating, must have been known to him, actual, dominant, with plenary power of disposition.

*Grantello v. U. S.*, 37 Fed.(2) 117.

The evidence offered by the prosecution being insufficient to sustain a possible verdict of guilty, the Court erred in denying appellant's motion made at the close of the prosecution's case for a directed verdict of acquittal, to which ruling appellant noted an exception (T.R. 115).

**SECOND POINT RAISED: THE ARREST AND SUBSEQUENT  
SEIZURE WERE ILLEGAL**

That the Court erred in denying defendant's petition made in writing to quash arrest and for dismissal on all the grounds urged in said written petition which was filed on April 29, 1944 (Paragraph 7, Assignment of Errors, T.R. 31).

That the Court erred in admitting in evidence during the course of the trial a package which contained the narcotics described in the indictment, which was taken by the Federal narcotic agents unlawfully and

in violation of defendant's constitutional rights under the Fourth and Fifth Amendments of the Constitution of the United States (Paragraph 8, Assignment of Errors, T.R. 31).

That the Court erred in permitting testimony to be given during the course of the trial concerning the package containing the narcotics mentioned in the preceding paragraph, said seizure being in violation of defendant's constitutional rights under the Fourth and Fifth Amendments of the Constitution of the United States (Paragraph 9, Assignment of Errors, T.R. 31).

That the Court erred in overruling defendant's repeated objections made during the course of the trial to the admission of such evidence referred to in paragraph 8 and testimony in connection therewith (Paragraph 10, Assignment of Errors, T.R. 31).

The arrest of appellant was illegal and in violation of his constitutional rights. The agents did not observe a crime being committed in their presence, nor did they have reasonable or probable cause to believe a felony had been committed by appellant to justify his arrest and the subsequent seizure of the package found to contain narcotics, which evidence was introduced in the course of the trial against appellant.

It is evident from the evidence adduced that appellant was immediately placed under arrest and prior to the discovery of the package on the floor of the garage—at least, prior to ascertaining that the package contained

narcotics. When appellant was placed under arrest in the garage, the agents had not prior thereto observed a violation of any kind.

*Papani v. U. S.*, 847 Fed.(2) 160 (C.C.A. 9th Cir.);  
*Agnello v. U. S.*, 269 U.S. 20;  
*Poldo v. U. S.*, 55 Fed.(2) 866 (C.C.A. 9th Cir.);  
Secs. 836 and 837 Calif. Penal Code (arrests);  
Sec. 15 California Penal Code (crime);  
*U. S. v. Valisio*, 41 Fed.(2) 294;  
*Baldacci v. U. S.*, 42 Fed.(2) 567;  
*Baumboy v. U. S.*, 24 Fed.(2) 512.

Illegally obtained evidence cannot be used.

*Byars v. U. S.*, 273 U.S. 28;  
*U. S. v. Lefkowitz*, 285 U.S. 452;  
*Go-Bart v. U. S.*, 282 U.S. 344;  
*Brown v. U. S.*, 4 Fed.(2) 246.

Appellant, after arraignment and before plea, timely filed his petition to quash arrest and for dismissal substantially on the grounds hereinabove set forth (T.R. 5). On the hearing of said petition Agent Brady testified briefly (T.R. 34). His testimony disclosed that no violation had been committed in his presence, nor was there probable cause for the arrest of appellant. The petition should have been granted and appellant discharged; instead, the Court denied the petition, to which ruling appellant noted an exception (T.R. 7).

**THIRD POINT RAISED: THE TRIAL COURT ERRED IN ADMITTING DOCUMENTARY AND ORAL EVIDENCE CONCERNING THE HOSPITALIZATION AND TREATMENT OF APPELLANT AND HIS WIFE**

That the Court erred in denying defendant's motion made at the close of the case to strike out all testimony of witnesses concerning the hospitalization of defendants in a sanitarium and their examination and treatment there (Paragraph 11, Assignment of Errors, T.R. 31).

That the Court erred in admitting in evidence certain records made by the witness Dr. Francis Kearney entitled "Report to Division of Narcotic Enforcement" and all testimony in connection therewith, and in refusing to strike the same from the record (Paragraph 12, Assignment of Errors, T.R. 31-32).

That the Court erred in admitting in evidence testimony of witnesses, including Dr. Francis Kearney and Ellen Jones concerning the hospitalization of defendants in a sanitarium and their examination and treatment there, and a certain admission card of W. L. Baldwin to said sanitarium and hospital records entitled "Doctor's Orders" in the cases of W. L. Baldwin and Mrs. Baldwin (Paragraph 13, Assignment of Errors, T.R. 32).

That the Court erred in admitting in evidence the documentary and oral evidence mentioned in paragraphs 11, 12 and 13 herein, on the ground that such evidence related to and directly bore upon the confidential relationship of doctor and patient and as

such were privileged discussions, communications and records (Paragraph 16, Assignment of Errors, T.R. 32-33).

#### **Improper Cross-Examination and Rebuttal.**

In rebuttal the prosecution offered evidence, documentary and oral, to show appellant and his wife, under assumed names, entered a sanitarium shortly after their arrest. A doctor and a nurse employed at the sanitarium testified appellant and his wife were admitted to the sanitarium as drug addicts and were given medical treatment ordinarily accorded drug addicts, which included the administering of narcotic drugs (T.R. 161 to 178).

The documentary evidence consisted of an admission card for appellant under such assumed name of Baldwin (T.R. 175), several report cards presumably sent by the doctor to the State Narcotic Division containing information of appellant's hospitalization and treatment at the sanitarium (T.R. 164-165) and certain hospital records covering medication and treatment of appellant and his wife at the sanitarium (T.R. 177).

Appellant objected to the admission of the doctor's report cards to the State Narcotic Division, T.R. 162, 163, 165, 166, 167) which objection was overruled and exception noted (T.R. 163, 165, 166, 167).

Appellant also objected to the admission of the above mentioned hospital records, which objection was overruled and exception noted (T.R. 177). At the close of the case appellant moved to strike from the record all testimony concerning hospitalization of appellant and his wife at the sanitarium on the ground that such evidence was

irrelevant and not connected with the issues of the case and not binding upon appellant. The motion was denied and exception noted (T.R. 182).

It is contended by appellant that such evidence should not have been admitted and was highly prejudicial to appellant. Unquestionably the jury was greatly influenced in its verdict by this line of evidence which placed appellant in a bad light before the jury. In the first trial, when such evidence was not presented, the jury failed to reach a verdict of guilty. In the second trial with this evidence offered a verdict of guilty was quickly reached. It may well have been this particular evidence which turned the scale and lost the case for appellant.

*Estate of James*, 124 Cal. 653, 656.

This evidence was not relevant to the issues or the charges contained in the indictment, but touched upon an entirely different and collateral matter. Whether or not appellant and his wife were accorded treatment in a sanitarium or used narcotics had no tendency to prove or disprove the charges contained in the indictment, namely, possession and transportation of narcotics at the time designated in the indictment.

Obviously this line of evidence was introduced solely for the purpose of placing appellant and his wife in a bad light and degrading and prejudicing them in the eyes of the jury. This has been held to be an improper line of procedure prejudicial to a defendant in a case and a reversible error.

*Ingram v. U. S.*, 106 Fed.(2) 863;

*People v. Vatek*, 71 Cal. App. 453, 468;

*People v. Kruvosky*, 53 Cal. App. 744;  
*Estate of Gird*, 157 Cal. 534, 546;  
*People v. Crandall*, 125 Cal. 129, 133;  
*People v. Chin Hane*, 108 Cal. 597, 606;  
*People v. Montezuma*, 117 Cal. App. 125, 134;  
*Little v. U. S.*, 93 Fed.(2) 401, 408.

See also:

*Salerno v. U. S.*, 61 Fed.(2) 419, 424;  
*Lennon v. U. S.*, 20 Fed.(2) 490;  
*Terzo v. U. S.*, 9 Fed.(2) 357, 358;  
*Berger v. U. S.*, 295 U.S. 78.

It is significant that the prosecution did not introduce this line of evidence in its case in chief, but waited until rebuttal to spring a surprise upon appellant that he was not prepared to meet. A witness may not be impeached by evidence of particular wrongful acts other than a conviction for a felony.

*People v. Casanova*, 54 Cal. App. 439, 445.

See also:

*People v. Adams*, 76 Cal. App. 178, 184;  
*People v. Jones*, 78 Cal. App. 554, 559;  
*Calif. Code of Civil Procedure*, Sec. 2051;  
*People v. Quinn*, 111 Cal. App. 614, 617.

The Federal rule is aptly enunciated in *McKune v. U. S.*, 296 Fed. 480, 481, where the Court said:

“It has long been settled that testimony from other witnesses of particular instances of misconduct is improper mode of discrediting, because of the confusion

of issues and waste of time that would thus be involved, and because of the unfair surprise to the witness, who cannot know what variety of false charges may be specified and cannot be prepared to expose their falsity."

See also:

*Conner v. U. S.*, 7 Fed.(2) 313 (C.C.A. 9th Cir.).

The same rule prevails in other states. See:

*Crow v. State*, 230 S.W. 148 (89 Tex. Cr. 149);

*Daniels v. Starnes*, 61 S.W.(2d) 548;

*State v. Johnson*, 101 So. 250 (156 La. 875);

*Cutchin v. City of Roanoke*, 74 S.E. 403 (113 Va. 452);

*Terry v. State*, 74 So. 756 (15 Ala. App. 665);

*Underwood Typewriter Co. v. Shouldis*, 253 S.W. 935 (Tex. Civ. App.);

*Birmingham Union R. Co. v. Hale*, 8 So. 142 (90 Ala. 8);

*Tarling v. People*, 194 Pac. 939, 940 (69 Colo. 477).

Said the Court in the latter case:

"The objection to impeaching a witness by evidence of specific acts is that all persons can be supposed ready to defend their general reputation of veracity, if attacked, but are not prepared at all times to defend as to a specific act."

See also:

*F. W. Stock & Sons v. Dellapenna*, 105 N.E. 378, 379 (217 Mass. 503).

The evidence related to a purely collateral matter.

*People v. Bell*, 96 Cal. App. 503, 506;  
*People v. Vatek*, supra;  
*People v. Williams*, 52 Cal. App. 609;  
*People v. Chin Hane*, supra;  
*Estate of James*, supra;  
*People v. Montezuma*, supra;  
*Little v. U. S.*, supra;  
*Salerno v. U. S.*, supra;  
*Lennon v. U. S.*, supra;  
*Terzo v. U. S.*, supra;  
*Berger v. U. S.*, supra;  
*Ingram v. U. S.*, supra.

While it may be true that appellant stated he did not use narcotics, nevertheless no objection to such irrelevant questioning was forthcoming from the prosecution (T.R. 142). On cross-examination of appellant by the prosecution, in order to lay the foundation for the introduction of the rebuttal evidence of the doctor and the nurse and the sanitarium records that the prosecution knew very well was purely collateral and had no place in the record, appellant was again asked questions by the prosecution for the purpose of eliciting answers denoting the non-use of narcotics by appellant and denying treatment for the cure of a narcotic habit (T.R. 146); whereupon the prosecution offered the evidence concerning the sanitarium in rebuttal to contradict appellant in statements made in response to questions asked by the prosecution on cross-examination.

The prosecution should not have been permitted to enter upon this line of inquiry either by way of cross-examination or the introduction of evidence on rebuttal. It touched upon purely collateral issues.

*McKune v. U. S.*, supra;

*Cohen v. U. S.*, 56 Fed.(2) 28;

*Kaplan v. Schwartz*, 41 Fed.(2) 177;

*Vendetti v. U. S.*, 45 Fed.(2) 543;

*Steen v. Santa Clara Valley Mt. L. Co.*, 134 Cal. 355.

Testimony educed on cross-examination respecting immaterial or collateral matter is not open to contradiction.

*Kaplan v. Schwartz*, supra;

*U. S. v. Neverso*n, 12 D.C. 152;

*Austin v. U. S.*, 4 Fed.(2) 774;

*Safter v. U. S.*, 87 Fed. 329;

*Hanover Fire Ins. Co. v. Dallavo*, 274 Fed. 258;

*Union Pac. Ry. Co. v. Reese*, 56 Fed. 288;

*Filasto v. U. S.*, 211 Fed. 329;

*Yoder v. U. S.*, 71 Fed.(2) 85.

Nor was such evidence admissible for the purpose of disparaging appellant's credibility.

*Cohen v. U. S.*, supra.

Witnesses may be contradicted only in matters that are relevant to the issue.

*Yoder v. U. S.*, supra;

*Beyer v. U. S.*, 282 Fed. 225.

Appellant's answer as to matter collateral to the charge against him bound the prosecution, and it was error to admit testimony to rebut his answer.

*Smith v. U. S.*, 10 Fed.(2) 787.

**Use of Fictitious Name.**

It follows from the general rule also that a witness may not be impeached by showing the assumption of a fictitious name.

*People v. Buyle*, 22 Cal. App.(2) 143, 150.

Here the Court held:

"A witness may not be impeached by evidence of particular wrongful acts other than a conviction for a felony. (Code Civ. Proc., Section 2051.) It follows therefore that a witness may not be impeached by showing the assumption of a fictitious name or specific acts of unchastity. (27 Cal. Jur. 133.) Therefore the Court correctly denied cross-examination as to such matters. (*People v. Pappens*, 5 Cal. App.(2) 544.)"

Cross-examination of a witness as to the use of an assumed name has for its purpose the degrading of the witness.

*People v. Fleming*, 166 Cal. 357, 381.

It cannot be said that such testimony did not injure the defendant in the minds of the jurors.

*People v. Fleming*, supra.

See also:

*People v. Mohr*, 157 Cal. 734.

Said the Court in the latter case:

"The questions were all improper cross-examination. They were not in response to any portion of the direct examination and were obviously asked not for the purpose of discrediting the defendant as a witness but simply and solely for the purpose of reflecting upon his character as a man and creating the impression in the minds of the jurors that he was in the habit of going under assumed names, a matter 'not conducive to a good character for defendant'. (People v. Arlington, 123 Cal. 356.)"

See also:

*People v. Denby*, 108 Cal. 54;

*People v. Adams*, supra.

#### Privileged Communications Between Doctor and Patient.

Such evidence involved privileged communications between doctor and patient and bore on a collateral matter not within the issues of the prosecution. It was not proper impeachment. To permit such evidence is to require appellant to submit to forcible self-incrimination.

It is clear that the privileged communication between doctor and patient applies not only between the doctor but his immediate staff and the hospital. Under the California Statutes 1929, p. 380, as amended 1931, 1933, 1935 and 1937 (Deering's General Statutes, 5323) all physicians treating patients for narcotic addiction are required to report all details to the State Narcotic authorities. The privileged communication between physician and patient applies both in criminal and civil cases.

*Wigmore on Evidence*, 4th Ed., p. 3358.

The California Constitution grants immunity to a citizen from being a witness against himself.

Art. 1. Section 13 of *California Constitution*.

The Federal Constitution likewise grants immunity to a citizen from being a witness against himself.

Sixth Amendment of the *Federal Constitution*.

The California law provides for privileged communications between physicians and patients, and under the California law the relationship between physician and patient is privileged.

*C. C. P.* 1881.

**THE FOURTH POINT RAISED: THE TRIAL COURT ERRED IN ADMITTING IN EVIDENCE THE EXTRAJUDICIAL ADMIS- SIONS AND STATEMENTS OF APPELLANT AND HIS WIFE**

That the Court erred in admitting in evidence statements and admissions of defendants on the *ground* that they were illegally obtained by the authorities who did not take defendants seasonably before a United States Commissioner, and on the additional grounds that the corpus delicti had not been proved by testimony other than the extrajudicial statements and admissions of the defendants and that said statements and admissions were not part of the res gestae (Paragraph 15, Assignment of Errors, T.R. 32).

The admissions and statements of appellant and his wife were not part of the res gestae, were made in violation of appellant's constitutional rights and further were

not admissible because the corpus delicti had not been proven.

The statements and admissions of appellant were taken and made some hours after his arrest and not at the time of the arrest so as to be part of the res gestae.

The arresting officer is required to take a defendant immediately upon arrest before the nearest United States Commissioner for a hearing, commitment and bail.

18 U.S.C.A. 595;

*U. S. v. Puleston*, 106 Fed. 294;

*Saunders v. U. S.*, 73 Fed. 782.

Statements and admissions taken from a defendant before he has been brought before a committing magistrate as required by the statute are not admissible in evidence at the trial.

*U. S. v. Haupt*, 136 Fed.(2) 661;

*McNabb v. U. S.*, 318 U.S. 332;

*Gros v. U. S.*, 136 Fed.(2) 78.

The evidence offered did not connect appellant with the commission of either of the offenses alleged in the indictment. As to him the corpus delicti had not been proven.

Statements or admissions made by a defendant are not admissible as extrajudicial statements or admissions if the corpus delicti has not been proven.

*Tingle v. U. S.*, supra;

*Forte v. U. S.*, 94 Fed.(2) 236;

*Jordan v. U.S.*, 60 Fed.(2) 4;

*Flowers v. U. S.*, 116 Fed. 241;

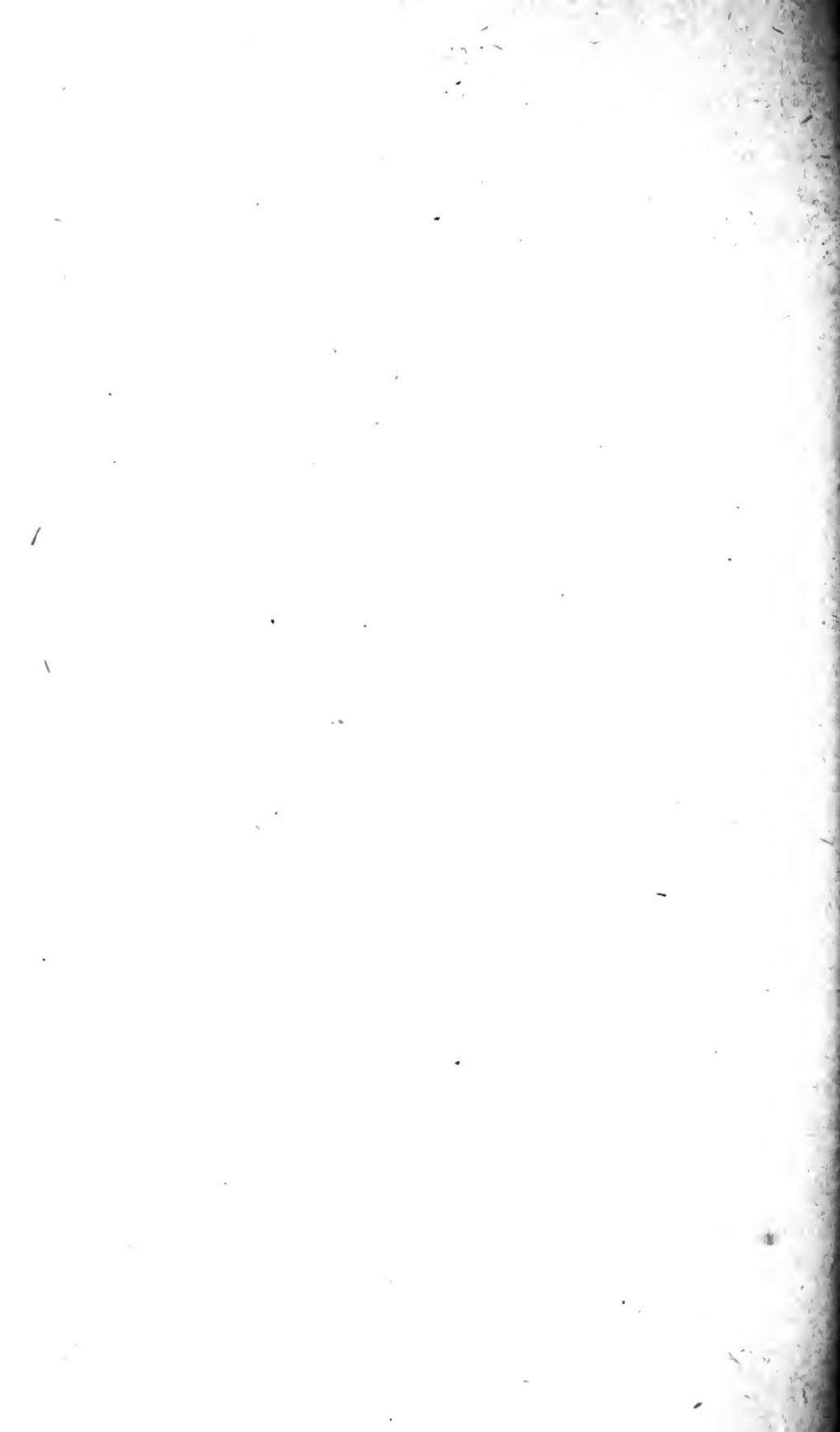
*Pearlman v. U. S.*, 10 Fed.(2) 460;  
*Forlini v. U. S.*, 12 Fed.(2) 63;  
*Deache v. U. S.*, 250 Fed. 566.

Dated: San Francisco, California,  
November 7, 1944.

Respectfully submitted,

SOL A. ABRAMS,

*Attorney for Appellant.*



No. 10,809

IN THE

**United States Circuit Court of Appeals  
For the Ninth Circuit**

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LAWRENCE W. BRADY,

*Appellant,*

VS.

UNITED STATES OF AMERICA,

*Appellee.*

---

**BRIEF FOR APPELLEE.**

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**FILED**

FEB 17 1945

**PAUL P. O'BRIEN,  
CLERK**



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No. 10,809

IN THE

**United States Circuit Court of Appeals**  
**For the Ninth Circuit**

---

LAWRENCE W. BRADY,

*Appellant,*

vs.

UNITED STATES OF AMERICA,

*Appellee.*

**BRIEF FOR APPELLEE.**

---

**JURISDICTIONAL STATEMENT.**

This is an appeal from the judgment of conviction (Tr. 17-18) of the District Court of the United States for the Northern District of California, Southern Division, convicting the appellant, after a jury trial, of a violation of the Jones-Miller Act (21 U.S.C. 174). The indictment, in two counts, alleged that he received, concealed and facilitated the concealment and transportation of narcotics, to-wit, heroin, which is a derivative and preparation of morphine (Tr. 2-3).

The Court below had jurisdiction under the provisions of Title 28, United States Code, Section 41, sub-division 2. The jurisdiction of this Honorable Court is invoked under the provisions of Title 28 United States Code, Section 225, subdivision (a) and subdivision (d).

**STATEMENT OF THE CASE.**

Appellant's statement of the case is incomplete and does not present to the Court an adequate picture of the facts upon which the conviction is based. Therefore, we make the statement which follows.

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**STATEMENT OF FACTS.**

The arresting officers first met the defendants, Mr. and Mrs. Brady, in the Sir Francis Drake Hotel in San Francisco in January, 1943. At that time, one of the officers had a conversation with the defendants concerning their possession of narcotics and their room was searched but no narcotics were found. Both of the defendants (one of whom is the appellant herein) were acquainted with the officers and knew that they were Agents of the Federal Bureau of Narcotics (Tr. 39; 66; 132; 153).

On April 4, 1944, the Agents saw the appellant drive his Cadillac automobile into a public garage at 840 Sutter Street, San Francisco, California, at about six o'clock in the evening. He left the garage and entered the Commodore Hotel, which is located across the street from the garage where he resided. About fifteen minutes later he came out of the hotel, accompanied by his wife, reentered the garage and drove out in his automobile.

The Agents followed his car in their automobile to the corner of Van Ness Avenue and Lombard Streets, where Mrs. Brady left the car and remained standing on the street corner for about five minutes. She did

not meet or talk to anyone during this period. He drove his car several blocks further down on Van Ness Avenue, and out of sight of the Agents, who had remained to observe the activities of Mrs. Brady. He returned in about five minutes. His wife reentered the automobile and he drove back to the same public garage on Sutter Street, followed by the Agents. The Agents had his car under constant observation at all times on its trip from the garage to Van Ness Avenue and Lombard Streets and on its return trip to the garage; the appellant and his wife did not meet or talk to anyone else during this time. Neither the appellant nor his automobile was under the observation of the Agents during the five minute interval which elapsed when he drove away from Van Ness Avenue and Lombard Street and returned to pick up his wife (Tr. 39-40; 45-46; 65-67; 76-77; 96-97).

When the appellant arrived at the garage in his automobile he made a left hand turn and entered the premises. The Agents followed immediately in their car. The Agents' car was paused at the curb facing into the garage at the time his car stopped about seventy feet inside the building. The Agents drove in and stopped about ten feet to the rear of his car in the same lane, which was the main runway of the garage. From their position at the curb, while driving into the garage and after they had stopped, the Agents could observe his car at all times (Tr. 40; 66-67).

When the Agents' car paused at the curb, they saw the appellant's car stop and saw Mrs. Brady get out

of the front right hand door. While the Agents' car was proceeding into the garage, Mrs. Brady walked towards it on the right hand side; as she passed the car she looked into it and continued walking. In this connection Agent William H. Grady testified: "As Mrs. Brady passed my car she looked at me directly in the eyes. She did not make any signs or gestures of any kind, but her expression changed considerably" (Tr. 59). When she reached a point opposite the right rear wheel of the Agents' car she stopped. By this time their car had come to a stop and the Agents had gotten out. Agent William H. Grady had Mrs. Brady under observation at all times after she had left appellant's automobile and was walking toward the entrance to the garage. When Agent Grady got out of his car Mrs. Brady was standing with her back toward him at a point opposite the right rear wheel of the Agents' car. It was at this point that he saw a package drop, apparently from the folds of her clothing, in a straight line to the floor, where it came to rest at a point approximately four to six inches from her feet (Tr. 40-41; 53-64).

Agent Grady testified: "When I got out of the car her back was toward me. I observed a package drop from the folds of her clothing to the cement floor in the garage. When I first observed the package it was in the process of falling."

"Q. About what distance was it from her body in relation to the package falling?

A. Well, it was as though it had fallen directly from the folds of her coat; I would say about six inches from her body, from her legs as it fell.

Q. Was it falling in a straight line or in an arc?

A. In a straight line.

Q. Falling down in a straight line?

A. Yes sir."

(Tr. 40-41.)

Agent James Ferguson corroborated this testimony (Tr. 97).

Agent Grady picked up the package and found it to be a brown envelope about two inches wide and about four and one-half inches long. It had two pieces of Kleenex-like material around it. He immediately opened it and examined the contents, which from his experience as a narcotics officer he believed to be heroin (Tr. 41). He asked Mrs. Brady what was in the package and where she had gotten it and she denied knowing anything about it. He then called out to the other Agents, "I have it", and placed Mrs. Brady under arrest (Tr. 42).

While Agent Grady was thus engaged Agents McGuire and Ferguson, who had left their car at the same time as Agent Grady, walked to the rear of the garage to a point near the vicinity of the hood of appellant's car where he was standing. These Agents had seen both Mr. and Mrs. Brady leave their car and Mrs. Brady walk toward the Agent's car (Tr. 68; 97-98). Agent McGuire had just about reached the appellant when he heard Agent Grady call out "I have it", whereupon he went up to the appellant and placed him under arrest. The appellant made some remarks and a threatening gesture and was hand-

cuffed by the Agents. Agent Ferguson had joined Agent McGuire within a few moments. The Agents walked back with the appellant to where Agent Grady and Mrs. Brady were standing and Agent McGuire asked Mrs. Brady if she had seen the narcotics, which she denied. He then told the appellant that he was under arrest for transporting narcotics as Agent Grady had seen Mrs. Brady drop the package (Tr. 68-69; 96-106).

He was then taken to his room in the Commodore Hotel across the street. The room and the appellant were searched, but no narcotics were found (Tr. 69). Agent McGuire testified that he had a conversation with the appellant in the hotel room in which he admitted having possession of the narcotics, stating that he had paid \$300.00 for it. He further offered to "make a deal" with the Agent by disclosing the name of the man from whom he had purchased the narcotics if this would help him.

Agent McGuire stated that the appellant said:

"This stuff isn't worth \$50.00 an ounce, and they are holding me up and robbing me of all the money I can put my hands on. What can I get out of the deal if I give you the man's name? What can I do to help myself in this proposition?" (Tr. 70).

He was informed by Agent McGuire that the only person who had the authority to consider this offer was the District Supervisor of the Federal Bureau of Narcotics at San Francisco, Mr. Joseph A. Manning. He requested that he be taken to Mr. Manning so that he could talk to him. Agent McGuire attempted to

communicate with Mr. Manning by telephone from the hotel room but was unable to locate him. This was some time between seven and eight o'clock in the evening as the arrest in the garage took place at approximately 6:45 o'clock P.M. The appellant and the Agents then went to the office of the Federal Bureau of Narcotics at 68 Post Street, San Francisco, where they waited for Mr. Manning, who came in about 11:30 o'clock in the evening (Tr. 70). During this interval the appellant, his wife and the Agents went out to dinner (Tr. 144).

Mr. Manning questioned the appellant and related the following:

"Agent McGuire had handed me a package, an envelope containing heroin. It was lying on my desk. Brady was across the desk from me. I asked him where he got this heroin. He said he got it from a fellow on Van Ness Avenue, and that he paid \$300 for it; that he had spent large amounts of money in making purchases of heroin, and that it was badly adulterated. He called it 'flea powder.' He told me his wife accompanied him to Van Ness Avenue and Lombard; that she left the car at that point; that he drove on three or four blocks where he met the man from whom he obtained the heroin. Brady then made the proposition to me that if I would turn him loose and wife loose and release the car, that he would help me catch other peddlers of narcotic drugs, peddlers more important than I knew about. I told him I could not very well accept such a proposition as that. I told him if he would help me catch these peddlers I would inform the United States Attorney of that fact, and the United States

Attorney would doubtless make such fact known to the Court, and that a lighter sentence in the case would be given him. He would not agree. He said if he or his wife went to jail and he lost his car he would 'just as soon go all the way as get just, say, a small sentence'. I told him that I didn't have the power to turn him loose under the circumstances. I then questioned Mrs. Brady separately under the same circumstances, the same time and place, and with the other agents out of the room."

(Tr. 107-108.)

The appellant was then placed in the City Prison to await his arraignment on the following day before the United States Commissioner (Tr. 75).

Both the appellant and his wife testified. He claimed that he drove out to Van Ness Avenue and Lombard Street with his wife so that she could look at an apartment; that he let her out of the car and proceeded down Van Ness Avenue to find a place to have the hood of his car fixed (Tr. 132-134). When he returned to the garage he was in the act of attempting to fix the hood himself when the Agents stepped up and placed him under arrest (Tr. 134-135; 80-81). He denied that he had admitted possession, purchase or ownership of the narcotics (Tr. 138; 139; 141-142; 144-145).

The appellant denied that he was a narcotic addict or that he had ever used narcotics. In this connection he testified (in relating a conversation purportedly had with Agent McGuire): "Somebody has convinced

you I am a narcotic user. No matter what I can do I can't prove to you, or convince you, I am not a user, that I have nothing to do with narcotics \* \* \*" (Tr. 139). He further testified: "\* \* \* I have nothing to do with narcotics" (Tr. 139). "I wouldn't know where to turn to buy narcotics. I do not know any big shots. I do not know any narcotic peddlers. I do not know where I could get narcotics" (Tr. 141). "I never purchased narcotics. I didn't see narcotics. I never used any narcotics" (Tr. 141). "I am not a user of narcotics. I do not use narcotics in any way, shape or form. I never have and I hope I never will" (Tr. 142).

On *cross-examination* the appellant testified: "I have nothing to do with narcotics or peddlers \* \* \* I do not associate with addicts. If people are addicts I will say I don't know it. If I know they are addicts I deliberately stay away from them, because I don't care anymore about narcotics or dope than the average citizen does. I hate them just as bad; \* \* \*" (Tr. 146).

And further:

"I am not a narcotic addict, nor have I ever been" (Tr. 146).

He denied that he had ever undergone treatment for the narcotic habit. On *cross-examination* he testified:

"I have never undergone treatment for the cure of the narcotic habit. On April 6th of this year I was admitted to the Patterson Sanitarium in San Leandro under the name of W. L. Bald-

win, for a nervous breakdown. My wife was admitted with me, under the name of Alice Baldwin. She had a side ailment. We both went over there for a rest cure. If you will look at the books you will see it. We were both admitted for a nervous breakdown. That was right after the arrest, and I was so ashamed and so disgraced that I didn't even want to see myself. While my wife and I were in the Patterson Sanitarium, to my knowledge, we did not receive any narcotics administered to us. I entered that sanitarium on April 6th and left on April 11th. My wife was there from April 6th until April 16th. She had side trouble."

(Tr. 146.)

On *redirect examination* he testified:

"We entered the Patterson Sanitarium under the name of Baldwin simply because we were both so ashamed and disgraced over this narcotic charge. I didn't want to see my friends. I wanted to get away. My wife had a side trouble. I don't know just what it was, the doctor there didn't seem to know, but it was giving considerable (134) trouble. When we entered the hospital we signed as entering for a rest cure. That was a day or so after the arrest on this charge."

(Tr. 147.)

Irving Cowan, produced as a witness by appellant, testified that he was at the time of the trial of this case serving a one-year sentence imposed by the State of California as a result of having been convicted of the possession of heroin (Tr. 116). That he had known the appellant for three or four years and was at one

time employed by him (Tr. 116-117). That on the day in question he was standing outside the garage and saw the two cars drive in, that at that moment he saw a man, known to him as Frenchy, from whom he had previously bought narcotics, toss a white package into the garage from the ramp. That he called out to this man to wait but that he drove off in an automobile (Tr. 123-124).

On *cross-examination* he testified that he did not see where the package landed in the garage, and, although he saw Agent Grady pick up something from the floor a few minutes later, he did not know that what Agent Grady picked up was the package he had seen thrown.

Hess Moskowitz, called as a witness by appellant, testified that he, too, had been outside the garage when the Agent's car entered. That he saw Agent Grady pick up something from the floor. That at that time he did not know the appellant but had met him once at the race track prior to the trial, at which time the appellant asked him to testify (Tr. 150-151).

On *cross-examination* he testified as follows:

"As I walked past the garage and saw the green coupe drive into the garage and saw Mr. Grady jump out of the car and grab Mrs. Brady's arm, that is all that I remember seeing right at the time. Later on I saw other people around the front of the garage, five or six people. At the time the car drove into the garage and Grady jumped out and grabbed the woman, Mrs. Brady,

I did not see anybody in that vicinity other than Grady and Mrs. Brady. I do not know Mr. Cowan nor do I know a man by the name of Frenchy, I didn't see anybody there."

(Tr. 152.)

In rebuttal, the Government introduced the testimony of Francis Kearney, M.D. (Tr. 161-173) and Ellen Jones, R.N. (Tr. 174-178).

On *direct examination* Dr. Kearney testified that he is a licensed physician and surgeon in the State of California with his offices located in Hayward, California. That in the course of his practice he has occasion to treat patients in the Patterson Sanitarium in San Leandro. That he is familiar with the diagnosis of drug addiction, and also with the treatment for drug addiction. On April 6, 1944 (two days after appellant's arrest on the instant charge), he was called to the Patterson Sanitarium to treat a Mr. Baldwin, whom the witness identified as Mr. Brady, the appellant (Tr. 161). That at that time he diagnosed his case as narcotic addiction and prescribed a treatment for narcotic addiction which he described (Tr. 162).

On *cross-examination* the witness testified that he knew why the appellant was in the hospital but did not have any record with him. Counsel for appellant requested the record and counsel for the Government reopened the direct examination and introduced Government's Exhibits Nos. 2 and 4 (Tr. 162-167). Government's Exhibit No. 2 was a card entitled

"Report to Division of Narcotic Enforcement, 156 State Building, Civic Center, San Francisco" (Tr. 164). Government's Exhibit No. 4 was a similar card (Tr. 166-167).

The witness testified that it is a law of the State of California that a doctor who prescribes narcotics must file with the Division of Narcotics Enforcement a record of the fact that he is treating an addict and that he has prescribed certain treatment. The witness testified that Government's Exhibits Nos. 2 and 4 were the records which applied to the appellant under the name of Baldwin and that he had forwarded Exhibit No. 4 to the State authorities when the appellant left the hospital.

Again on *cross-examination* the witness testified that he had examined the appellant on the first day that he saw him at the Sanitarium. That he had never seen him before and that he had not been his patient previously, although he recalled that either the appellant or his friends had communicated with him prior to the appellant's admission to the hospital requesting that he make an examination. That he based his opinion that the appellant was a narcotic addict on his admission that he had used heroin intravenously for some time, on his examination and on the appellant's clinical record (Tr. 168-170).

Ellen Jones testified that she is a trained nurse employed at Patterson Sanitarium in San Leandro where she is the Superintendent of Nurses. That on April 6, 1944 the appellant was admitted to the Sani-

tarium under the name of Baldwin. That she supervised the medication prescribed by the doctors. That the appellant was being treated for drug addiction; that she administered some of the treatment herself, which consisted of injections of morphine and that she had the records of the hospital pertaining to the appellant in her possession (Tr. 174-175). She introduced in evidence Government's Exhibit No. 5, the admittance card of the appellant (Tr. 175), and Government's Exhibit No. 6, the appellant's clinical record, commonly called the "chart".

Agent Thomas E. McGuire testified that on the day of the arrest he was outside the Commodore Hotel from approximately one o'clock in the afternoon until he followed the appellant in his automobile, except for a short interval when he followed Mr. Cowan. That about three o'clock in the afternoon he saw the witness Cowan leave the hotel and followed him to either Eddy Street or Turk Street and Mason Street. That he returned to his position outside the Commodore Hotel and remained there until the appellant drove out in his car and that he did not see Mr. Cowan return to the hotel (Tr. 178-179).

In surrebuttal the appellant testified as follows:

"I was in the hospital approximately three days before the doctor came. I did not send for the doctor, and I don't know who did. I never saw the man before he showed up that night. I never asked the doctor for anything but a sleeping pill, which he gave me and which I took with water, and he gave me another brown pill and

treated me for nerves. I never asked him for anything. I never knew what I was getting in the way of medicine and nobody explained it to me. Different nurses gave me the medicine. I saw the doctor only the one time he came to examine my wife. I never told the doctor that my wife and I were addicted to drugs. He was not sent for for that. He was sent for to relieve my wife of excruciating pain in her side. If he administered any drugs he did it of his own accord. When I entered the hospital I did not tell them that I was an addict or that I was there for addiction treatment. I told them that my wife had an extremely bad case of nerves, and I also had had nerves. It was emphatically understood that I was to leave as soon as my wife was better. I stayed three or four days."

(Tr. 181-182.)

On *cross-examination* he testified that he did not receive any injection by the use of a hypodermic needle intravenously while in the Sanitarium.

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#### **QUESTIONS ON APPEAL.**

Appellant relies upon the following alleged errors:

- I. Insufficiency of the evidence to sustain the verdict.
- II. The arrest and subsequent seizure were illegal.
- III. Documentary and oral evidence of hospitalization and treatment of appellant was admitted in error.

IV. Extra-judicial statements and admissions of appellant were admitted in error.

These points will be answered in order.

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#### **ARGUMENT.**

##### **I. THE EVIDENCE IS SUFFICIENT TO SUPPORT THE VERDICT.**

The appellant made two full and complete confessions in which he admitted his guilt and described in detail the manner in which he committed the crime with which he was charged.

These confessions, coupled with the circumstantial evidence adduced by the Agents, which corroborated in every detail the narration of events given in the confessions, were more than ample to support the verdict.

A deliberate, voluntary confession of guilt is among the most effectual proofs in the law and constitutes the strongest evidence against the party making it that can be given of the facts stated in such confession.

“A confession, if freely and voluntarily made, is evidence of the most satisfactory character. Such a confession, said Eyre, C.B. 1 Leach, 263 ‘is deserving of the highest credit, because it is presumed to flow from the strongest sense of guilt, and, therefore, it is admitted as proof of the crime to which it refers’.”

*Hopt v. Utah*, 110 U.S. 574, 584; reaffirmed in *Sparf v. United States*, 156 U.S. 51, 55.

See also:

*Anderson v. United States*, 124 F.(2d) 58 (Reversed on other grounds in 318 U.S. 350, 63 S. Ct. 599, 87 L.Ed. ....);

*Rosenfeld v. United States*, 202 F. 469.

The appellant was charged with concealing and facilitating the concealment and transportation of narcotics. He confessed that he had purchased, possessed and transported the narcotics and the Agents observed him at the times and places which he described.

The Statute under which he was indicted, 21 U.S.C. Section 174, provides, in part:

"Whenever on trial for a violation of this section the defendant is shown to have or to have had possession of the narcotic drug, such possession shall be deemed sufficient evidence to authorize conviction unless the defendant explains the possession to the satisfaction of the jury."

Appellant's argument that the evidence is insufficient, together with his citation of general principles of law on the subject, is convincing only if we disregard the confessions. Granting the confessions, the evidence is conclusive; and the confessions must be accepted provided they were freely and voluntarily made, were corroborated and the jury was properly instructed. (These points will be discussed, *infra*, in Section IV.

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**II. THE ARREST AND SUBSEQUENT SEIZURE WERE LEGAL.****(a) The Arrest Was Legal.**

The appellant's Motion to Quash Arrest was properly denied.

A felony was committed in the presence of the Agents when the appellant's wife threw, or dropped, the package containing the narcotics to the floor of the garage. Agent Grady testified that from his experience as a Narcotic Agent he believed the package contained narcotics; this belief was strengthened by his knowledge that she knew him to be a Narcotic Agent, that her expression changed when she saw him in the automobile and that immediately thereafter she attempted to dispose of the package by throwing it to the floor. It is common knowledge that narcotic violators attempt to dispose of the contraband upon apprehension.

Having positive proof that the appellant's wife had been in possession of narcotics just a few seconds after she left the automobile driven by the appellant, that she tried to dispose of them when she recognized the Agents, that she had, to the Agents' own knowledge, been riding with the appellant in his automobile just prior thereto, that she had waited on a street corner for no apparent reason while the appellant drove off and returned, certainly gave the Agents probable cause to believe, as reasonable and prudent officers, that the appellant was guilty of concealing and facilitating the transportation of the narcotics or had, at least, aided and abetted his wife in so doing.

In discussing probable cause, the Supreme Court in *Carroll v. United States*, 267 U.S. 132, 161, 45 S.Ct. 280, 69 L. Ed. 543, 3 ALR 790, said:

"If the facts and circumstances before the officer are such as to warrant a man of prudence and caution in believing that the offense has been committed, it is sufficient."

See also:

*Papani v. United States* (CCA-9), 84 F.(2d) 160;

*Rocchia v. United States* (CCA-9), 78 F.(2d) 966;

*Poldo v. United States* (CCA-9), 55 F.(2d) 866;

*Mattus v. United States* (CCA-9), 11 F.(2d) 503;

*United States v. Bell* (D.C. Cal.), 48 F. Supp. 986.

N.B. We respectfully call the Court's attention to the fact that, contrary to the statement made in appellant's brief, the evidence clearly shows that the appellant was arrested *after* Agent Grady had recovered and opened the package, determined to his satisfaction that it contained narcotics and called out "I have it" (Tr. 68).

**(b) Appellant Cannot Complain of Illegal Search and Seizure.**

The right to complain because of an illegal search and seizure is a privilege personal to the wronged or injured party and is not available to anyone else.

The evidence introduced at the trial was not seized from the person of the appellant nor from premises owned by him or to which he had the right of possession. On the contrary, it was picked up from the floor of a public garage where it had been thrown or dropped by the appellant's wife. Furthermore, the appellant disclaimed ownership of the property which was seized.

It is obvious that he cannot complain of an illegal search and seizure.

*Ingram v. United States* (CCA-9), 113 F.(2d) 966;

*McDaniel v. United States*, 294 F. 769, certiorari denied 264 U.S. 593, 44 S.Ct. 453, 68 L. Ed. 866.

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### **III. EVIDENCE OF APPELLANT'S HOSPITALIZATION AND TREATMENT WAS PROPERLY ADMITTED.**

The appellant, on direct examination, emphatically stated that he was not a narcotic addict, that he had never seen, purchased or used narcotics, that he did not know any narcotic peddlers, that he wouldn't know where to buy narcotics, that he had "nothing to do with narcotics".

While proof of his narcotic addiction would not be relevant as proof of his guilt of the crime charged and could not be offered in the Government's case in chief, by his own testimony he "opened the door" to cross-examination and rebuttal on this point.

A party who first introduces evidence which is irrelevant to the issues cannot assign error on the admission of evidence from the adverse party relating to the same matter.

*Warren Live Stock Co. v. Farr*, 142 F. 116, 73 CCA 340.

If evidence not strictly admissible is introduced by one party, and not withdrawn, the other party may cross-examine as to such evidence and offer evidence in rebuttal thereof.

*Watts v. Southern Bell Telephone & Telegraph Co.*, 66 F. 453, affirmed in *Southern Bell Telephone & Telegraph Co. v. Watts*, 66 F. 460, 13 CCA 579.

Furthermore, even proof of distinct offenses is allowed to rebut an inference of mistake, want of guilty knowledge, wrongful purpose, or innocent intent. (In the instant case the cross-examination and rebuttal did not prove a distinct offense as narcotic addiction is not a violation of Federal law.)

*De Four v. United States* (CCA-9), 260 F. 596, certiorari denied 253 U.S. 487.

In the latter case the defendant, on trial for maintaining a house of ill fame, testified that she did not know of any practice of prostitution in the building and did not receive the impression that such was the case from certain incidents which occurred in her presence. It was held not to be error to admit evidence that she had previously conducted houses of ill fame.

Certainly, the only purpose of appellant's vociferous attempt to dissociate himself from any connection with narcotics or narcotic addicts was to create in the minds of the jury the inference that a person of such impeccable behavior in this regard could not be guilty of the crime of possessing narcotics and to support his contention that he had been "framed" by the Agents.

We respectfully submit that the interests of justice and its fair administration demand that the Government be permitted to rebut this type of self-serving testimony by a defendant.

See also:

*Shepard v. United States*, 290 U.S. 96, 54 S.Ct. 22, 78 L. Ed. 196,

and

*Haffa v. United States*, 36 F. (2d) 1, certiorari denied 281 U.S. 727, 50 S.Ct. 240, 74 L. Ed. 1114;

where it was held that testimony that defendant had admitted bribing prohibition agents was admissible to rebut his testimony that he had never engaged in the liquor business.

Furthermore, the cross-examination and rebuttal was properly allowed for the purpose of testing the credibility of the witness.

The right to permit cross-examination for this purpose is discretionary with the Court.

*United States v. Ball*, 163 U.S. 662, 16 S.Ct. 1192, 41 L. Ed. 300.

In *Mahoney v. United States*, 26 F. (2d) 902, the Court said:

"Undoubtedly a person accused of crime, who offers himself as a witness, occupies precisely the same position as any other witness, and may be examined \* \* \* generally as to all matters which affect his credibility \* \* \*"

"The theory upon which the latter (cross-examination) is conducted is that its primary objective is the ascertainment of truth, not by eliciting positive evidence directly bearing on the facts, but by furnishing a means of testing the truthfulness and credibility of witnesses."

*Underhill's Criminal Evidence* (1935 Ed.), Sec. 400, p. 807.

We respectfully submit that it would be a strange rule of law which would permit the defendant, as a witness, to commit perjury by claiming that he was not addicted to the use of drugs and "knew nothing about them" and would deny to the Government the right to prove by cross-examination and rebuttal that while awaiting trial he had undergone treatment for narcotic addiction. This evidence certainly tested his credibility as a witness.

We also respectfully call the Court's attention to the fact that appellant did not object to these questions on cross-examination nor to the testimony of the doctor and nurse in rebuttal. He objected only to the introduction of the records (Government's Exhibits Nos. 2, 3, 4, 5, 6 and 7). If the oral testimony was admitted without objection we fail to under-

stand how the admission of the records which merely corroborated that testimony could be prejudicial.

If an objection is not made nor an exception noted any error now assigned as to it should not be considered by the Appellate Court.

*Sartain v. United States*, 16 F. (2d) 704;

*Degnan v. United States*, 271 F. 291;

*O'Neil v. Vermont*, 144 U.S. 323, 12 S.Ct. 693, 36 L. Ed. 450;

*Rosen v. United States*, 271 F. 651.

Appellant also contends that evidence showing his use of a fictitious name was improperly admitted. This might be so if the purpose of its introduction was to degrade the witness and for no other legitimate purpose. It is clear that in the instant case it was not offered for that purpose but, on the contrary, was necessary in order to identify the defendant as the person who had received treatment at the Sanitarium.

(a) **Communications Between Physician and Patient Are Not Privileged in Criminal Cases.**

Such communications were not privileged at common law.

*Wigmore on Evidence* (1940 Edition), Sec. 2380.

There is no Federal statute in point and we have been unable to find a Federal case which determines the question as a matter of Federal law as distinguished from an interpretation of a statute of some particular State.

No such privilege exists under California law in *criminal* cases. Section 1881 (subdivision 4), California Code of Civil Procedure, limits the rule to *civil actions*. Chapter II of Title X of the California Penal Code (Sections 1321-24) "Who May be Witnesses in Criminal Actions", while expressly preserving the rule as to husband and wife, is significantly silent concerning physician and patient.

*People v. Lane*, 101 Cal. 513, 516;  
*People v. West*, 106 Cal. 89;  
*People v. Griffith*, 146 Cal. 339;  
*People v. Warner*, 117 Cal. 639.

N.B. As we are concerned here with the *absence* of a restrictive rule of evidence we need not consider the problem presented by *United States v. Reid*, 12 How. 361, 363, 13 L. Ed. 1023; *Logan v. United States*, 144 U.S. 263, 36 L. Ed. 429 and *Rosen v. United States*, 245 U.S. 467, 62 L. Ed. 406, as to whether the State or the Federal rule shall apply. It would be otherwise if we were relying upon a permissive rule of evidence of a State.

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#### **IV. EXTRAJUDICIAL STATEMENTS PROPERLY ADMITTED.**

##### **First: Confession of Appellant's Wife.**

The appellant's wife, who was also a defendant in the case, has not appealed. We are not aware of any theory of law which would permit the appellant to attack, in this appeal, the admissibility of his wife's confession. In any event, all of the grounds advanced in support of the admissibility of the appellant's con-

fessions apply with equal force and effect to those of his wife.

**Second: Confessions Not Admitted as Part of the Res Gestae.**

The appellant's statements to the Officers clearly amounted to confessions.

"A 'confession' is a declaration made by the accused admitting his participation in the crime with which he is charged and is a direct acknowledgment of guilt."

*Gulotta v. United States*, 113 F. (2d) 683.

They were admitted in evidence as such and not as "spontaneous utterances while under the influence of the transaction". Hence, the principles of law pertaining to *res gestae*, relied upon by the appellant, do not apply.

*Busch v. United States*, 52 F. (2d) 79, certiorari denied in *Greible v. United States*, 284 U.S. 687, 52 S.Ct. 209, 76 L. Ed. 580.

**Third: Confessions Admitted in Violation of Constitutional Rights.**

Because of the broad statement in Appellant's Brief, that his confessions were admitted in violation of his "constitutional rights", it is not clear whether he relies upon the ground that the confessions were inadmissible because involuntarily made or upon the more specific ground (as his citations would indicate), that they were inadmissible because made after the arrest and before he was brought before a committing

magistrate. In order that the matter may be considered fully, we will discuss both phases of the problem.

**(a) The Confessions Were Voluntarily Made.**

A confession is presumed to be free and voluntary.

*Ah Fook Chang v. United States*, 91 F. (2d) 805;

*Murphy v. United States*, 285 F. 801, certiorari denied, 261 U.S. 617, 43 S.Ct. 362, 67 L. Ed. 829.

The burden of proof that the confession is free and voluntary is not upon the Government. The confession is admissible without proof of its free and voluntary character and the burden is upon the defendant to establish that the confession was involuntary.

*Hartzell v. United States*, 72 F. (2d) 569, certiorari denied 293 U.S. 621, 55 S.Ct. 216, 79 L. Ed. 708;

*Gray v. United States* (CCA-9), 9 F. (2d) 337.

The fact that the accused was under arrest at the time of confession is not of itself sufficient to exclude the confession.

*McNabb v. United States*, 318 U.S. 332, 63 S. Ct. 608;

*Lisbena v. California*, 314 U.S. 219, 239-241;

*Ziang Sun Wan v. United States*, 266 U.S. 1, 14;

*Sparf v. United States*, supra.

The fact that the confession was made to a person in authority does not render it inadmissible.

*Perovich v. United States*, 205 U.S. 86, 27 S.Ct. 456, 51 L. Ed. 722.

Without commenting on the evidence at length, we merely call the Court's attention to the following facts: the appellant was arrested at approximately 6:45 o'clock in the evening; he was then taken immediately to his hotel room across the street; between 7 and 8 o'clock that same evening he confessed to Agent McGuire and offered to "make a deal"; upon being told that he would have to discuss this matter with Mr. Manning he requested that he be taken to him; he was taken to the office of the Federal Bureau of Narcotics; he went out to eat with the Agents and when Mr. Manning came in at 11:30 o'clock that evening he again confessed, repeating the same story that he had told to Agent McGuire.

There was not a scintilla of evidence introduced at the trial to suggest that the confessions were secured by means of duress, threats, promises, coercion, persuasion, fear, hope of leniency or improper influence.

*Lisbena v. California*, supra;

*Ziang Sun Wan v. United States*, supra;

*Bram v. United States*, 168 U.S. 532, 18 S.Ct. 183, 42 L. Ed. 568;

*Wilson v. United States*, 162 U.S. 613, 623, 16 S.Ct. 895, 899, 40 L. Ed. 1090;

*Sparf v. United States*, supra;

*Hopt v. Utah*, supra;

*McAfee v. United States*, 105 F. (2d) 21, 70 App. D.C. 142;  
*Murphy v. United States*, supra;  
*3 Wigmore on Evidence*, 1940 Ed., Section 882.

Furthermore, the appellant denied having made the confessions; he admitted having the conversations during which the confessions were allegedly made and offered no proof that these conversations were involuntary, nor did he move to exclude the confessions. He merely objected on the grounds that they violated his constitutional rights (Tr. 69, 107), and then proceeded to offer his version of the conversations which contradicted that of the Agents and, if believed, would indicate that he had not confessed. The jury could properly determine which version was the true one, giving due weight to the credibility of witnesses.

The proper method of raising the question of the involuntary nature of a confession in the trial Court is by a motion to exclude, or at least, by some appropriate objection which will apprise the Court that this point is raised and enable the Court to conduct a hearing in the absence of the jury to determine the substantiality of the motion or objection.

*McNabb v. United States*, supra;  
*Tooisgah v. United States*, 137 F. (2d) 713;  
*Mangum v. United States* (CCA-9), 289 F. 213;  
*Rossi v. United States* (CCA-9), 278 F. 349.

We respectfully submit that when this procedure is not followed and the appellant does not claim that the circumstances under which the confession was

made show it to have been involuntary but, on the contrary, testifies to the conversation but denies the confession, he should not be permitted to raise the point for the first time on appeal.

The testimony concerning the circumstances under which the confessions were made does not show them to be "inherently coercive" so as to bring them within the rule of

*Ashcraft v. Tennessee*, 322 U.S. 143.

Nor, in view of the discussion of *McNabb v. United States*, supra, is there a "plain error" so as to bring it within the rule announced by this Honorable Court in

*Gros v. United States*, 136 F. (2d) 879.

**(b) The Doctrine of the "McNabb Case" Not Applicable.**

Appellant relies upon *McNabb v. United States*, supra (and, we presume, upon *Anderson v. United States*, 318 U.S. 350, 63 S.Ct. 599, 87 L. Ed. ....), as authority for the broad proposition that "statements and admissions taken from a defendant before he has been brought before a committing magistrate as required by the statute are not admissible in evidence at the trial". In other words, that *any* confession in a federal case, whether voluntary or not, is *ipso facto* inadmissible in evidence if made between the time of arrest and appearance before a committing magistrate, however short.

Appellant contends that it is an absolute rule by which every confession, regardless of its truth or falsity, regardless of the circumstances under which

it was secured, regardless of its voluntary nature, must be excluded unless, prior to the time it was given, a defendant has been arraigned before a committing magistrate. In other words, arraignment is a *sine qua non*.

We respectfully submit that this is not the doctrine of the *McNabb* and *Anderson* decisions. These two cases have been followed in the following cases:

*Runnels v. United States* (CCA-9), 138 Fed. (2d) 346;

*United States v. Haupt*, 136 Fed. (2d) 661;

*Gros v. United States* (CCA-9), *supra*.

The distinction between these cases and the instant case is clear: In the *McNabb* case two of the defendants were put in a barren cell and kept there for fourteen hours. For two days they were subjected to unremitting questioning by numerous officers. One defendant was questioned continuously for five or six hours. In the *Gros* case the defendant was confined for five days; in the *Haupt* case for several weeks: in the *Runnels* case for seventeen days. The confessions were obtained during these varying periods and before the defendants were taken before a committing magistrate.

In our opinion, the basis of the decision in the *McNabb* case is that there was illegal detention of a prisoner *coupled with aggravating circumstances*, circumstances which were deemed by the Supreme Court to be contrary to proper conduct of federal prosecutions.

This has been made clear in

*United States v. Mitchell*, 322 U.S. 65,

which embodies a clarification of the *McNabb* case. In that case Justice Frankfurter, delivering the opinion of the Court said, at page 67:

"Inexcusable detention for the purpose of illegally extracting evidence from an accused, and the successful extraction of such inculpatory statements by continuous questioning for many hours under psychological pressure, were the decisive features in the *McNabb* case which led us to rule that a conviction on such evidence could not stand."

There Mitchell was taken into custody at his home at 7 o'clock in the evening and taken to the police station. Within a few minutes of his arrival he admitted his guilt. He was not taken before a committing magistrate for eight days. Yet the Court said:

"Undoubtedly his detention during this period was illegal. \* \* \* But, in any event, the illegality of Mitchell's detention does not retroactively change the circumstances under which he made the disclosures. These, we have seen, were not elicited through illegality. Their admission, therefore, would not be used by the Government of the fruits of wrongdoing by its officers. Being relevant, they could be excluded only as a punitive measure against unrelated wrongdoing by the police. Our duty in shaping rules of evidence relates to the propriety of admitting evidence. This power is not to be used as an indirect mode of disciplining misconduct."

(At 70-71.)

See also:

*United States v. Klee*, 50 E. Supp. 679 at 684, where the Court said that in the *McNabb* case the Supreme Court was not "laying down a mechanical rule or creating a situation of rigidity".

The *Mitchell* case, except for the delay in being arraigned, is practically on "all fours" with the instant case. Here the appellant was arrested at 6:45 o'clock in the evening, he confessed between 7 o'clock and 8 o'clock, he went out to a restaurant with the Agents, he confessed again at 11:30 o'clock after waiting this period of time at his own request; he was then placed in the City Jail for arraignment before the United States Commissioner the next day (Tr. 75).

As the Supreme Court said in the *Mitchell* case:

"Here there was no disclosure induced by illegal detention, no evidence was obtained in the violation of any legal rights, but instead \* \* \* the prompt acknowledgment by an accused of his guilt, and the subsequent rueing apparently of such spontaneous cooperation and confession of guilt." (at 70.)

See also:

*McNabb v. United States*, 142 F.(2d) 904, certiorari denied, 65 S.Ct. 114.

#### **Fourth: Appellant's Confession Was Corroborated.**

In this Circuit in order to justify a conviction, the evidence corroborating the confession need not be

such as to, independently, establish the *corpus delicti*.

*Wiggins v. United States* (CCA-9), 64 F.(2d) 950; certiorari denied 290 U.S. 657, 54 S.Ct. 72, 78 L. Ed. 569;

*Wynkoop v. United States* (CCA-9), 22 F.(2d) 799;

*Pearlman v. United States* (CCA-9), 10 F.(2d) 460.

In the latter case the Court (citing *Mangum v. United States* (CCA-9), 289 F. 213, 216, said (at p. 462):

“Evidence *aliunde*, however, as to the *corpus delicti*, need not be such as to alone establish the fact beyond a reasonable doubt. It is sufficient if, when considered in connection with the confession, it satisfies the jury beyond a reasonable doubt that the offense was in fact committed, and the plaintiff in error committed it.”

See also,

*Gulotta v. United States*, supra.

In

*Pong Wing Quong v. United States* (CCA-9), 111 F.(2d) 751,

this Honorable Court held that proof that the appellant placed a customs label on a trunk containing opium with the probable effect of preventing customs inspection was sufficient proof of the *corpus delicti* to authorize the admission of the appellant's confession.

We respectfully submit that the evidence in this case showing possession of the narcotics by the ap-

pellant's wife a few seconds after she left the automobile driven by appellant, her attempt to dispose of them upon recognizing the Agents, the fact that she stood on the street corner while appellant drove off and returned and all of the circumstances surrounding the transaction was sufficient evidence to establish the *corpus delicti* and permit the admission of appellant's confession.

**Fifth: Instructions Must Be Accepted as Correct.**

As no exceptions were taken to the Court's instructions, they must be accepted, on appeal, as having been correct.

*Kitrell v. United States*, 79 F.(2d) 259, certiorari denied, 296 U.S. 643, 56 St. Ct. 248, 80 L. Ed. 457;

*Busch v. United States*, supra.

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**CONCLUSION.**

We respectfully submit that a reversal of this conviction would be a grave miscarriage of justice. The appellant is a man who has made use of every trick, scheme and prevarication of which his nimble mind could conceive to escape the just punishment of his crime. When he thought it was to his advantage, he confessed; when he could not "make a deal", audacious in its scope, to avoid prosecution entirely, he glibly recanted. He blandly committed perjury on the witness stand, feeling secure that it would not be discovered, when his falsity was exposed he attempted to

hide behind the technicality of privilege, although, he, himself, put his good character in issue.

For the reasons stated in our Brief we respectfully submit that the judgment should be affirmed.

Dated, San Francisco,  
February 14, 1945.

Respectfully submitted,

FRANK J. HENNESSY,

United States Attorney,

JAMES T. DAVIS,

Assistant United States Attorney,

*Attorneys for Appellee.*

No. 10908

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United States  
Circuit Court of Appeals  
For the Ninth Circuit.

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LENORE S. ROBINETTE,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

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Transcript of the Record

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Upon Petition to Review a Decision of the Tax Court  
of the United States

FILED

NOV 24 1944

PAUL P. O'BRIEN,  
CLERK



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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in italic; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in italic the two words between which the omission seems to occur.]

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APPEARANCES:

For Taxpayer:

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JOHN J. GOLDBERG, Esq.,

For Comm'r:

H. R. HORROW, Esq.

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Docket No. 1176

LENORE S. ROBINETTE,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent.

DOCKET ENTRIES

1943

- Apr. 5—Petition received and filed. Taxpayer notified. Fee paid.
- Apr. 6—Copy of petition served on General Counsel.
- May 3—Answer filed by General Counsel.
- May 3—Request for hearing in San Francisco, California, filed by General Counsel.
- May 8—Notice issued placing proceeding on San Francisco, California, calendar. Service of answer and request made.
- Oct. 14—Hearing set November 22, 1943—San Francisco, California.

1943

Nov. 26—Hearing had before Judge Arundell on the merits. Stipulation of facts filed. Briefs due January 10, 1944. Reply briefs Jan. 31, 1944.

Dec. 27—Transcript of hearing 11/26/43 filed.

1944

Jan. 11—Motion for leave to file the attached brief, brief lodged, filed by General Counsel. 1/12/44 granted and served 4/4/44.

Apr. 1—Motion for leave to file the attached printed brief, filed by taxpayer. 4/3/44 granted.

Apr. 3—Brief filed by taxpayer.

Apr. 4—Copy of motion and brief served on general Counsel.

Apr. 27—Memorandum findings of fact and opinion rendered, Judge Arundell, Div. 7. Decision will be entered for the respondent. Copies served.

Apr. 27—Decision entered. C. R. Arundell, Div. 7.

May 25—Motion for rehearing and reconsideration, affidavit and memorandum of points and authorities in support thereof, filed by taxpayer.

Jun. 5—Order denying petitioner's motion for rehearing and reconsideration, entered.

Jun. 6—Copy of order and motion served on General Counsel.

Aug. 31—Bond in the amount of \$1331.84 approved and ordered filed.

**1944**

**Aug. 31**—Stipulation of venue filed.

**Aug. 31**—Petition for review by the U. S. Circuit Court of Appeals, 9th Circuit, filed by taxpayer.

**Aug. 31**—Affidavit of service by mail of petition for review filed.

**Sep. 28**—Designation of contents of record filed by taxpayer.

**Sep. 28**—Affidavit of service by mail of designation of record filed by taxpayer.

**Oct. 11**—Certified copy of an order from U. S. Circuit Court of Appeals, 9th Circuit, extending time to November 10, 1944 to prepare and transmit the record, filed. [1\*]

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The Tax Court of the United States

Docket No. 1176

**LENORE S. ROBINETTE.**

Petitioner,

vs.

**COMMISSIONER OF INTERNAL REVENUE,**  
**Respondent.**

**PETITION**

The above named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (Bureau symbols IRA:90-D CWB)

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\*Page numbering appearing at top of page of original certified Transcript of Record.

dated January 9, 1943, and as a basis of her proceeding alleges as follows:

1. The petitioner is an individual whose residence is at 143 Isabella Avenue, Atherton, California. The return for the period here involved was filed with the Collector for the District of Florida.

2. The notice of deficiency (a copy of which is attached and marked Exhibit "A") was mailed to the petitioner not earlier than January 9, 1943.

3. The taxes in controversy are income taxes for the taxable year beginning February 1, 1939 to December 31, 1939, [2] and the amount in controversy is \$665.92.

4. The determination of tax set forth in the said notice of deficiency is based upon the following errors:

(a) The respondent erred in ruling that distributions received by petitioner during the taxable year from Metropolitan Properties Company, a corporation, in the aggregate sum of \$7,916.60 were and are 100% taxable or that any portion of such distributions in excess of \$2,047.63 (being 25.865% of \$7,916.60) was or is taxable.

(b) The respondent erred in ruling that petitioner's income should be increased by \$5,868.97, being the difference between the aggregate of distributions in the sum of \$7,916.60 received by taxpayer from the Metropolitan Properties Company, a corporation, during the taxable year and the portion of such distributions which is taxable, to-wit, \$2,047.63.

(c) The respondent erred in ruling that earnings capitalized by Cole-French Company in 1928 under the circumstances hereinafter set forth continued to be earnings available for dividends in the hands of Cole-French Company upon its dissolution and in the hands of Metropolitan Properties Company after dissolution and the receipt by Metropolitan Properties Company of all of the assets of Cole-French Company as hereinafter set forth.

(d) The respondent erred in determining that there is a deficiency in the income tax of the petitioner for the [3] taxable year in the sum of \$665.92, or in any sum whatever.

5. The facts upon which the petitioner relies as the basis of this proceeding are as follows:

(a) During the taxable year petitioner was the owner of 833-1/3 shares of the capital stock of the Metropolitan Properties Company, a corporation. During the taxable year the petitioner received from said corporation \$7,916.60. The petitioner is informed and believes, and based upon such information and belief, states that of said distributions made by said corporation a portion thereof was made from earnings and profits accumulated since February 28, 1913, and the remainder thereof was made from capital of said corporation. On or about February 26, 1940, on the basis of information furnished to the Commissioner of Internal Revenue by said corporation, the Commissioner tentatively determined that the said distributions were and are taxable to the extent of 25.865% thereof and nontaxable to the extent of 74.135% thereof.

On or about March 5, 1940 said corporation gave written notice to the respondent of the said determination of the Commissioner and on the basis thereof the respondent made her return of income received during the taxable year and filed the same with the Collector for the District of Florida where the respondent resided at that time.

(b) At the time that said corporation, Metropolitan Properties Company, made the said distributions to the respondent and its other stockholders, said corporation had earnings and [4] profits accumulated since February 28, 1913 equal only to 25.865% of said distributions and that the entire balance of said distribution so made to respondent and the other stockholders was made from capital of said corporation.

(c) In December 1936 Metropolitan Properties Company owned all of the issued and outstanding shares of stock of Cole-French Company, a corporation. On December 24, 1936, Cole-French Company was dissolved and all of its assets were distributed to Metropolitan Properties Company. Upon the date of such dissolution and liquidation of Cole-French Company, said company had no accumulated earnings or profits and had a deficit in its earned surplus account of \$5,141.31. In 1925 Cole-French Company issued and sold 2500 shares of its capital stock of the par value of \$100 each. The selling price was \$100 per share, payable \$10 upon the issuance of said shares and the balance on call of the Board of Directors if and when such call should be made. Cole-French Company received

an aggregate of \$25,000 on account of the sale of said stock at the time of the issuance thereof in 1925. On December 27, 1928, Cole-French Company had earnings in excess of \$225,000 and had not at any time called on the purchasers of said shares of stock for any additional payment on account thereof. On December 27, 1928, the Board of Directors of Cole-French Company adopted a resolution instructing the secretary to make a journal entry as of December 31, 1928, debiting the profit and loss account with [5] \$225,000 and crediting the capital account with said sum of \$225,000, so that the credit to the capital stock account should equal the par value of the 2500 shares of stock issued. Pursuant to said resolution the secretary made said journal entry and noted in said journal that said shares of stock had become fully paid. No distribution of stock or other securities or money or other property was made by Cole-French Company to its stockholders by reason of or in connection with the said capitalization of earnings.

Wherefore, the petitioner prays that this Court may hear the proceeding and determine that there is no deficiency due from the petitioner for the tax-

able year beginning February 1, 1939 and ending December 31, 1939.

LENORE S. ROBINETTE

Petitioner

JESSE H. STEINHART

JOHN J. GOLDBERG

Counsel for Petitioner

111 Sutter Street, San Francisco,  
California [6]

State of California

City and County of San Francisco—ss.

Lenore S. Robinette, being duly sworn, says that she is the petitioner above named, and that she has read the foregoing petition and is familiar with the statements contained therein, and that the facts stated are true.

LENORE S. ROBINETTE

Subscribed and sworn to before me this 3rd day of April, 1943.

[Seal] VIOLET NEUENBURG  
Notary Public in and for the City and County of San Francisco, State of California.

My Commission Expires Jan. 3, 1947. [7]

**EXHIBIT A**

**SN-IT-1**

Treasury Department  
Internal Revenue Service  
**74 New Montgomery Street**  
San Francisco, California

Jan. 9, 1943

Office of  
Internal Revenue  
Agent in Charge  
San Francisco Division  
IRA:90-D CWB

Mrs. Lenore S. Robinette,  
143 Isabella Avenue  
Atherton, California

Madam:

You are advised that the determination of your income tax liability for the taxable year February 1, 1939 to December 31, 1939, discloses a deficiency of \$665.92 as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency mentioned.

Within 90 days (not counting Sunday or a legal holiday in the District of Columbia as the 90th day) from the date of the mailing of this letter, you may file a petition with The Tax Court of the United States for a redetermination of the deficiency.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Internal Revenue Agent in Charge,

San Francisco, California for the attention of Conference Section. The signing and filing of this form will expedite the closing of your return by permitting an early assessment of the deficiency, and will prevent the accumulation of interest, since the interest period terminates 30 days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully,

GUY T. HELVERING,

Commissioner,

(Signed) By F. M. HARLESS

Internal Revenue Agent in  
Charge

Enclosures:

Statement

Form of waiver. [8]

### STATEMENT

San Francisco

IRA:90-D

CWB

Mrs. Lenore S. Robinette  
143 Isabella Avenue  
Atherton, California

Tax Liability for the Taxable Year February 1,  
1939 to December 31, 1939

	Liability	Assessed	Deficiency
Income Tax .....	\$1,154.43	\$ 488.51	\$ 665.92

In making this determination of your income tax liability, careful consideration has been given to

your protest dated September 8, 1942, and to the statements made at the conference held on September 25, 1942.

A copy of this letter and statement has been mailed to your representative, Mr. John J. Goldberg, 111 Sutter Street, San Francisco, California, in accordance with the authority contained in the power of attorney executed by you and on file in this office.

#### ADJUSTMENTS TO NET INCOME

Net income as disclosed by return (item 20, page 1)....\$10,798.74  
Unallowable deductions and additional income:

(a) Dividends not reported .....	5,868.97
Net income adjusted .....	\$16,667.71

#### EXPLANATION OF ADJUSTMENTS

(a) Information of record in this office discloses that during the taxable period ended December 31, 1939 you received distributions in the amount of \$7,916.60 on stock of the Metropolitan Properties Company. In your return you included in gross income only \$2,047.63 (25.865 percent of \$7,916.60) of the distributions received. It is held that the distributions received are 100 percent taxable. The net income is, accordingly, increased by \$5,868.97. [9]

#### COMPUTATION OF TAX

Net income adjusted—11 months' period .....\$16,667.71

Net income placed on annual basis .....	\$18,182.95
(\$16,667.71 x 12)	
( 11 )	

Less:

Personal exemption .....	\$2,500.00
Credit for dependents .....	800.00
	3,300.00
Balance (surtax net income).....	\$14,882.95

Less:

Earned income credit (10 percent of \$3,000.00).....	300.00
Net income subject to normal tax.....	\$14,582.95
Normal tax at 4 per cent on \$14,582.95.....	583.32
Surtax on 14,882.95.....	679.47
Total tax on annual basis .....	\$ 1,262.79
Tax per period 11/12 of \$1,262.79 .....	\$ 1,157.56
Less: Income tax paid at the source.....	3.13
Correct income tax liability.....	\$ 1,154.43
Income tax assessed :	
Original, account No. 201130—District of Florida .....	\$532.92
Less :	
Previous allowance .....	44.41
Net assessment .....	488.51
Deficiency of income tax .....	\$ 665.92

[Endorsed]: Filed T.C.U.S. Apr. 5, 1943. [10]

[Title of Tax Court and Cause.]

## ANSWER

Comes now the Commissioner of Internal Revenue, respondent above named, by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and for answer to the petition filed by the above-named petitioner, admits and denies as follows:

1. Admits the allegations contained in paragraph 1 of the petition.
2. Admits the allegations contained in paragraph 2 of the petition.
3. Admits the allegations contained in paragraph 3 of the petition.
4. (a), (b), (c), and (d). Denies that the determination of tax set forth in said notice of deficiency is based upon errors as alleged in paragraph 4 and subparagraphs (a) to (d), inclusive, thereunder, of the petition.
5. (a) Admits the allegations contained in the first two sentences of subparagraph (a) of paragraph 5 of the petition; denies the remaining allegations contained in said subparagraph. [11]  
(b) Denies the allegations contained in subparagraph (b) of paragraph 5 of the petition.  
(c) Admits the allegations contained in subparagraph (c) of paragraph 5 of the petition, except that the allegations in the third and last sentences of said subparagraph are denied.
6. Denies generally and specifically each and every allegation in the petition not hereinbefore admitted, qualified, or denied.

Wherefore, it is prayed that the Commissioner's determination be approved and the petitioner's appeal denied.

[Signed]

J. P. WENCHEL, TMM  
Chief Counsel, Bureau of  
Internal Revenue.

Of Counsel:

ALVA C. BAIRD,  
Division Counsel.

T. M. MATHER  
HARRY R. HORROW

Special Attorneys,  
Bureau of Internal Revenue.

[Endorsed]: Filed T. C. U. S. May 3, 1943. [12]

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[Title of Tax Court and Cause.]

## MEMORANDUM FINDINGS OF FACT AND OPINION

This proceeding involves a deficiency in income taxes for the period February 1, 1939 to December 31, 1939 in the amount of \$665.92. The sole question is whether a distribution by a corporation of which the petitioner was a stockholder was a distribution of earnings and profits of the corporation or was, in part, a distribution of capital.

### FINDINGS OF FACT

The petitioner is an individual residing in the State of California. Her income tax return for the period here involved was filed with the Collector of Internal Revenue for the district of Florida, in which state she was at that time resident. [13]

During the year 1939 the petitioner owned 833 1/3 shares of stock of the Metropolitan Properties Company (hereinafter called Metropolitan), a corpora-

tion organized under the laws of the State of California on November 21, 1924. As a stockholder of that corporation she received in the period involved distributions from the corporation amounting to \$7,916.60. The petitioner returned as taxable income \$2,047.63 of that amount, or 25.865%. The return was based upon advice from the corporation that of the total distribution to her, \$5,868.97, or 74.135%, was a distribution from capital and not from earnings, profits, or surplus.

Metropolitan was, on December 24, 1936, a sole stockholder of the Cole-French Company. Immediately prior to December 31, 1928, Cole-French had issued an outstanding 2,500 shares of its capital stock of the par value of \$100 per share. These shares had been issued in 1925, pursuant to a subscription agreement by the terms of which the subscribers paid to the corporation \$10 per share, agreeing to pay the balance of \$90 per share in such amounts and at such times as called for by resolution of the board of directors. On December 27, 1928 the corporation had earnings in excess of \$225,000 and had at no time called on the stockholders for any additional payments. The board of directors on that date adopted the following resolution:

Resolved that the Secretary be authorized and instructed to make a journal entry as of December 31st, 1928, debiting the profit and loss account with \$225,000 and crediting the capital account with said sum of \$225,000 so that the credit to the capital stock account shall

equal the par value of 2,500 shares of stock issued and

Further Resolved that the Secretary be authorized and instructed to certify upon the face of all outstanding certificates of capital stock that the same are now fully paid up. [14]

Pursuant to the adoption of the resolution, the secretary, by a journal entry on December 31, 1928 debited the profit and loss account with \$225,000 and credited the capital account with a like amount, reflecting the capital stock as fully paid. The books of the Cole-French Company reflected the transaction as follows:

Assets	Before	After
Office funds .....	\$ 25.00	\$ 25.00
Bank of California, N. A.....	21,008.48	21,008.48
Union Trust Co. ....	1,089.90	1,089.90
Union Trust Co.—Savings .....	1,895.72	1,895.72
Accounts receivable .....	47,994.50	47,994.50
Notes receivable .....	2,250.00	2,250.00
Furniture & Fixtures .....	\$3,558.16	
Depreciation .....	324.00	3,234.16
	<hr/>	<hr/>
Stocks and Bonds .....	342,385.93	342,385.93
Personal account .....	201.84	201.84
Advances and deposits .....	31.27	31.27
	<hr/>	<hr/>
	\$420,116.80	\$420,116.80
	<hr/>	<hr/>

Liabilities	Before	After
Wm. J. Boyd .....	\$ 1,895.72	\$ 1,895.72
Loans payable—(Calif. Ink) .....	100,000.00	100,000.00
Notes payable—Bank of Calif.....	50,000.00	50,000.00
Capital stock issued .....	25,000.00	250,000.00
Surplus .....	30,347.72	18,221.08
Profit and Loss (1928).....	212,873.36	.....
	<hr/>	<hr/>
	\$420,116.80	\$420,116.80
	<hr/>	<hr/>

The stockholders of the Cole-French Company reported no taxable income by reason of the transaction, nor was any taxable income by reason thereof included in their income by the Commissioner.

The 2,500 shares of stock were thereafter carried on the books of the corporation as a capital stock liability in the sum of \$250,000 and were at all times since December 31, 1928 considered by the corporation as fully paid shares.

On December 24, 1936, the Cole-French Company, in complete liquidation, distributed all of its assets, subject to liabilities, to Metropolitan, its sole stockholder, in exchange for all of its shares, which [15] were then canceled and the corporation forthwith dissolved. At this time the books of Cole-French Company reflected assets and liabilities as follows:

Assets

Revolving Funds .....	\$ 25.00
Bank of California, N. A.....	13,803.77
Union Trust Company .....	22,993.04
Anglo California Trust Co. ....	672.07
Accounts receivable .....	297,291.48
Notes receivable .....	800.00
Furniture & Fixtures .....	\$2,753.08
Depreciation .....	2,112.00
<hr/>	
Stocks and Bonds .....	674,647.32
Advances—Rodox .....	4,120.65
Deposit—Insurance .....	31.27
<hr/>	
	\$ 1,015,025.68

Liabilities

Suspense—Fortuna Mine .....	\$ 166.99
Capital Stock .....	1,020,000.00
Surplus (deficit) .....	5,141.31
<hr/>	
	\$ 1,015,025.68

The item of capital stock in the amount of \$1,020,000 included \$250,000, consisting of \$25,000 paid prior to December 31, 1928 on account of the purchase price of the 2,500 shares above mentioned, and the \$225,000 transferred to the capital account from surplus in 1928.

The distribution by the Cole-French Company to Metropolitan was in pursuance of the complete liquidation of a wholly-owned subsidiary; by virtue of the provisions of Section 112 (b)(6) of the Revenue Act of 1936 no gain or loss to Metropolitan was recognized. The fair market value of the assets, less liabilities, received by Metropolitan exceeded the adjusted basis of the stock of Cole-French in the hands of Metropolitan by not less than \$200,000, but during 1939 the fair market value of those assets, still retained by Metropolitan, had declined by more than \$200,000.

In arriving at the deficiency herein involved the Commissioner determined that the Cole-French Company, as of December 24, 1936, had earnings, profits, and surplus amounting to \$244,968.69, [16] which sum included the amount of \$225,000 transferred from surplus to capital in 1928; and, further, that this amount constituted part of the earnings and profits of Metropolitan.

The earnings and profits of Metropolitan were sufficient to cover the entire amount of the distribution to stockholders during the taxable period in question.

## OPINION

Arundell, Judge: Two questions are raised: (1) whether the transfer from surplus to capital of \$225,000 by the Cole-French Company, thus making its shares fully paid up, served to reduce its earnings and profits available for distribution in that amount; and (2) whether the earnings and profits of Cole-French distributed to Metropolitan in liquidation became the earnings and profits of the latter company. It is conceded that if these transactions did not operate to transmute earnings into capital, Metropolitan had sufficient earnings in 1939 to render the distributions in that year taxable in their entirety.

In our opinion the transfer of \$225,000 from surplus to capital on the books of the Cole-French Company did not impair or diminish the earnings and profits of that corporation. Such a transaction is essentially equivalent to a stock dividend, and the stockholder realizes no gain. *Michaels v. McLaughlin*, 20 Fed. (2d) 959; *J. F. Carlston*, 22 B.T.A. 217. A stock dividend which is not taxable does not operate to diminish the corporate earnings for the purpose of determining the taxability of subsequent distributions. *August Horrmann*, 34 B.T.A. [17] 1178; *John K. Beretta*, 1 T.C. 86, affd. — Fed. (2d) — (March 3, 1944). Section 115(h), Revenue Act of 1936.<sup>1</sup>

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<sup>1</sup>Sec. 115. Distributions by Corporations.

(h) Effect On Earnings And Profits Of Distributions of Stock.—The distribution (whether before January 1, 1936, or on or after such date) to

The amount of \$225,000 remained, therefore, a part of the earnings and profits of the Cole-French Company to the time of liquidation.

The question thus becomes whether, upon liquidation, the earnings and profits of the liquidated subsidiary become the earnings and profits of the parent corporation, or are taken into capital, as the petitioner contends.

A long and uniform line of decisions stemming from *Commissioner v. Sansome*, 60 Fed. (2d) 931, certiorari denied 287 U.S. 667, has removed all doubt from this question. In the Sansome case it was held that accumulated earnings and profits of an original or subsidiary company transferred to a successor or parent in a tax-free reorganization, remain for purposes of distribution earnings or profits of the successor or parent. This principle has been applied in a variety of circumstances in *United States v. Kauffmann*, 62 Fed. (2d) 1045; *Helen V. Crocker*, 29 B.T.A. 733; *Murchison's Estate v. Commissioner*, 76 Fed. (2d) 641; *Reed Drug*

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a distributee by or on behalf of a corporation of its stock or securities or stock or securities in another corporation shall not be considered a distribution of earnings or profits of any corporation.

(1) if no gain to such distributee from the receipt of such stock or securities was recognized by law, or

(2) if the distribution was not subject to tax in the hands of such distributee because it did not constitute income to him within the meaning of the Sixteenth Amendment to the Constitution or because exempt to him under section 115(f) of the Revenue Act of 1934, or a corresponding provision of a prior Revenue Act.

Company v. Commissioner, 130 Fed. (2d) 288; Harter v. Helvering, 79 Fed. (2d) 12.

Equally within the principle enunciated in the above decisions is a transfer in complete liquidation, where no gain or loss is recognized. Estate of Howard H. McClintic, 47 B.T.A. 188. No gain or loss was recognized in the transfer to Metropolitan in complete liquidation of the Cole-French Company by reason of the provisions of section 112(b)(6) of the Revenue Act of 1936.

The earnings and profits of Cole-French, therefore, remained the earnings and profits of Metropolitan, adequate, in 1939, to cover the distributions here in question.

Nor does Helvering v. Credit Alliance Corp., 316 U.S. 107, affirming 122 Fed. (2d) 361, point to a different conclusion. In that case it was held that a dividends paid credit under section 27(f) of the Revenue Act of 1936 was not to be denied by reason of the fact that the distribution did not constitute a taxable dividend in the hands of the distributee. There is no suggestion that the rule announced in the Sansome case, *supra*, would not apply and that the distribution in the hands of the transferee would not continue to retain its character as undivided profits. Indeed, the Circuit Court of Appeals rather pointedly so states.

It follows that the deficiency as determined by the Commissioner must stand.

Decision will be entered for the respondent.

Entered:

Entered: April 27, 1944. [19]

(Copy)

The Tax Court of the United States  
Washington

Docket No. 1176

LENORE S. ROBINETTE,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent.

## DECISION

Pursuant to the determination of the Court, as set forth in its Memorandum Findings of Fact and Opinion entered April 27, 1944, it is

Ordered and Decided: That there is a deficiency in income tax for the period February 1, 1939 to December 31, 1939, in the amount of \$665.92.

Enter.

(Seal) (S) C. R. ARUNDELL,  
Judge.

Entered April 27, 1944. [20]

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[Title of Tax Court and Cause.]MOTION BY PETITIONER FOR  
REHEARING AND RECONSIDERATION

Now comes the petitioner in the above entitled and numbered proceeding and moves the Court for a rehearing and reconsideration of its opinion and

decision in the above entitled cause entered April 27, 1944, particularly with respect to that portion of its opinion contained on pages 6 and 7 thereof to the effect that on the basis of *Commissioner v. Sansome*, 60 Fed. (2d) 931, and *Estate of Howard H. McClintic*, 47 B.T.A. 188, the earnings and profits of Cole-French Company upon liquidation became the earnings and profits of Metropolitan Properties Company, and upon such rehearing and reconsideration to decide that the cases of *Commissioner v. Sansome*, supra, and *Estate of Howard H. McClintic*, supra, are not applicable to the liquidation of a subsidiary in 1936, prior to the amendment in 1938 of Section 115(h) of the Revenue Act of 1936, and, accordingly, to enter a decision for petitioner.

This motion is made on the following grounds:

1. The said portion of the opinion of the Court above referred to and contained on pages 6 and 7 thereof, and [22] the decision entered in pursuance thereto, are not in accordance with law and are erroneously based on the case of *Commissioner v. Sansome*, supra, and the principle enunciated therein, for the reason that the principle of *Commissioner v. Sansome* is not applicable to the liquidation of a subsidiary corporation and for the further reason that the question of the extent to which the principle of *Commissioner v. Sansome* should be applied was before the Congress in the preparation of the Revenue Act of 1936 and at that time the Congress by means of Section 115(h) of said Act determined to limit the application of the principle of Commis-

sioner v. Sansome to tax-free reorganizations and not to extend the same to liquidations of subsidiaries, as was subsequently done by the amendment of Section 115(h) in the Revenue Act of 1938;

2. After petitioner received respondent's brief and noted therein that respondent relied upon Commissioner v. Sansome supra, and upon the asserted application of the principle of that case to the liquidation of a subsidiary in the case of Estate of Howard H. McClintic, supra, and also upon Section 115(h) as amended by the Revenue Act of 1938 and upon Article 115-11 of Regulations 94 accompanying the Revenue Act of 1936 and enlarging without authority the scope of Section 115(h), petitioner determined to file a reply brief as permitted by the order of the Court herein in order to point out that the facts in Estate of Howard H. McClintic, supra, were not the same as in the case at bar and therefore not controlling herein, that the codification of the principle of the Sansome case in 1936 in terms limited the same to tax-free reorganizations and omitted the application thereof to liquidations of subsidiaries, that the amendment in 1938 ex- [23] tending the principle of the Sansome case to the liquidation of subsidiaries has been expressly held by the Supreme Court of the United States to have no effect on liquidations in 1936 and that the attempt of the Treasury Department in Regulations 94, Article 115-11, to apply the principle of the Sansome case as set forth in Section 115(h) of the Revenue Act of 1936 to the liquidation of subsidiaries was unauthorized and has been so held;

3. The said brief of respondent was received by petitioner on April 10, 1944, whereupon petitioner's attorneys immediately commenced the preparation of the said reply brief and had completed the same in condition to be furnished to the printer for printing on April 29, 1944 with the intention of applying to the Court for such slight additional time as might elapse over and above twenty days from receipt of respondent's brief, within which to file the reply brief with the Court. On April 30, 1944 petitioner sent a telegram to the Court advising it of the said situation, whereupon on May 1, 1944 petitioner received a telegram from the clerk of the Court to the effect that the opinion and decision had been entered on April 27, 1944, prior to the expiration of the twenty-day period within which petitioner assumed that her reply brief could be filed;

4. Petitioner's memorandum of points and authorities filed herewith presents the matters which would have been contained in petitioner's reply brief were it not for the prior entry of the opinion and decision herein and such points and authorities should be considered by the Court prior to the final disposition of this cause.

The facts with respect to the preparation of petitioner's reply brief and failure to file the same prior to the entry [24] of opinion and decision herein are set forth in the affidavit of petitioner's attorney, John J. Goldberg, filed herewith.

This motion, designated as a motion for rehearing and reconsideration, is intended as a motion to have the Court reconsider its opinion and decision herein

and thereafter to enter an opinion and decision herein in conformity with this motion, to-wit, an opinion and decision in favor of petitioner. The opinion of the Court was entered April 27, 1944 and received by petitioner on May 1, 1944. It is intended that this motion and the said affidavit and memorandum of points and authorities will be received and filed by the Court on or before May 27, 1944 so as to be within time for any and all motions referred to in Rule 19 of the Rules of Practice of the Court. Any delay which would cause such receipt and filing to occur later than May 27, 1944 will be occasioned by delay in the mails between San Francisco, California and Washington, D. C. Accordingly, as a part of this motion petitioner requests that the same be received and filed as within time under the said Rule 19 even though a delay of several days should occur by reason of loss of time in transit.

This motion is based on the statements herein contained, on the said affidavit of John J. Goldberg, on the said memorandum of points and authorities filed herewith and on all of the records on file in this cause.

Dated, San Francisco, California.

May 19, 1944.

JESSE H. STEINHART,  
JOHN J. GOLDBERG,

Counsel for Petitioner. [25]

[Title of Tax Court and Cause.]

AFFIDAVIT OF JOHN J. GOLDBERG IN  
SUPPORT OF MOTION FOR REHEAR-  
ING AND RECONSIDERATION

State of California,

City and County of San Francisco,—ss.

John J. Goldberg, being first duly sworn, deposes and says:

I am and have been at all of the times during the pendency of the above entitled cause one of the attorneys for petitioner herein and am the attorney who has personally handled the said cause and all proceedings therein on behalf of petitioner.

At the oral hearing of said cause in San Franesco, California on November 26, 1943 the Court allowed the parties forty-five (45) days within which to file an opening brief and twenty (20) days within which to file a reply brief. Thereupon in open Court the Clerk stated that the opening briefs should be filed on January 10 and reply briefs on Janmary 31. (Transcript, p. 17.) Due to illness which caused my absentee from my office and prevented [26] me from preparing the petitioner's opening brief within the time fixed, all of which appears in the records of the Court, the Court permitted petitioner to file her opening brief on April 3, 1944, the motion of petitioner to that effect having been granted on said date. A copy of the brief for respondent was mailed to me by the Clerk of the Court and was received at my office on April 30, 1944. There is no indication anywhere on the brief as to the date

on which said copy of respondent's brief was mailed from Washington, D. C., nor was I in any other manner advised as to the date of the mailing thereof. On the basis of the order of the Court above referred to I assumed, I believe properly, that petitioner was permitted to file a reply brief within twenty (20) days after April 10, 1944.

After examining respondent's brief and particularly respondent's reliance upon *Commissioner v. Sansome*, 60 Fed. (2d) 931, upon Estate of Howard H. McClintic, 47 B.T.A. 188, upon Section 115(h) as amended by the Revenue Act of 1938, and upon Article 115-11 of Regulations 94 accompanying the Revenue Act of 1936, I concluded that it was highly important to the interests of petitioner that a reply brief on behalf of petitioner be filed in order to point out the difference between the Sansome case and this one, the difference likewise between the McClintic case and this one, the fact that the rule of the Sansome case was codified in the Revenue Act of 1936, but limited to tax-free reorganizations, that the extension of such principle to the liquidation of subsidiaries was not made until 1938 and that neither the 1938 amendment nor the unauthorized attempt of Regulations 94 to enlarge the [27] scope of Section 115(h) of the Revenue Act of 1936 could be utilized to apply the principle of the Sansome case to a 1936 liquidation of a subsidiary.

I immediately commenced working on the preparation of the reply brief, in which I also included a discussion of the effect of the 1928 transaction of

Cole-French Company in transferring \$225,000 from surplus to capital. As in the case of petitioner's opening brief, I felt it would be of assistance to the Court if the brief were printed. The reply brief was made ready for the printer on Saturday, April 29, 1944. Having in mind that the reply brief should be filed within twenty (20) days, on May 1, 1944 (the twentieth day falling on Sunday), but feeling that the delay of a few days made necessary by printing the brief and mailing it to the Court would not prove objectionable to the Court in connection with a motion to extend the time for said reason, I sent a telegram to the Court on April 30, 1944, reading as follows:

"April 30, 1944.

The Tax Court of the United States  
Internal Revenue Bldg.,  
Washington, D. C.

Re Lenore S. Robinette against Commissioner  
Docket Number 1176. Petitioner's reply brief  
is being furnished to printer and will be for-  
warded to the court for filing during the week  
of May first together with formal motion for an  
extension of time within which to file reply  
brief. Respectfully yours

John J. Goldberg."

On Monday morning, May 1, 1944, I received a telegram from the Clerk of the Court reading as follows: [28]

"May 1, 1944.

John J. Goldberg, Esq.  
111 Sutter St.  
San Francisco, California

Retel opinion entered April twenty seventh  
copy mailed you same day.

B. D. Gamble, Clerk."

On the same day I sent the following telegram to  
the Clerk of the Court:

"May 1, 1944.

"B. D. Gamble, Clerk  
The Tax Court of the United States  
Washington, D. C.

Re Robinette Docket 1176. We received re-  
spondent's brief April 10. Court had ordered  
twenty days for reply brief so assumed peti-  
tioner's reply brief could be filed on or before  
April 30 which accounts for our telegram to  
you on April 30 explaining slight delay. Have  
not received opinion but believe reply brief  
would have been helpful to the court and may  
on that account move for reconsideration if  
opinion adverse.

John J. Goldberg."

The opinion of the Court was received later in the  
day on May 1, 1944.

I feel very strongly that the portion of the reply  
brief dealing with the Sansome and McClintic cases  
and Section 115(h) of the Revenue Acts of 1936  
and 1938 should have been before the Court before

its opinion herein was entered, particularly in view of the fact that the opinion itself makes no reference to Section 115(h) of either the [29] Revenue Act of 1936 or the Revenue Act of 1938 nor to the effect of the undisputed fact that the Congress did in 1936 codify the principle of the Sansome case as applied to tax-free reorganizations and did not codify such principle with respect to the liquidation of subsidiaries until 1938. It is the petitioner's position that this demonstrates the intention of Congress not to apply the rule of the Sansome case to a 1936 liquidation of a subsidiary and I believe the question of such application in 1936 under the particular circumstances of the 1936 enactment of Section 115(h) should appear in the Court's opinion to have been considered by it in order that the petitioner may know that the Court has given consideration to that proposition.

I believe the statement of the Court on page 17 of the transcript of the oral hearing herein allowing petitioner twenty (20) days within which to file a reply brief, coupled with the absence of any advice to petitioner or her attorneys as to the date when respondent's brief was mailed to petitioner from Washington, D. C., justified me in concluding that petitioner would be allowed to file a reply brief within twenty (20) days after the date on which her attorneys received respondent's brief. Had the entry of the Court's opinion and decision been delayed during such twenty-day period then it would appear reasonable that in view of my telegram to the Court sent on April 30, 1944, the Court would have allowed petitioner an additional few days within

which to print and mail her reply brief, and under those circumstances the points now made in the accompanying memorandum of points and authorities would have been before the Court and would have [30] been considered prior to the entry of the opinion and decision herein.

Under these circumstances, I believe it is fair and reasonable to request the Court to reconsider its opinion and decision herein on the basis of the accompanying memorandum of points and authorities and thereafter to render such opinion and decision herein as may appear to the Court to be required on the basis of such points and authorities.

JOHN J. GOLDBERG.

Subscribed and sworn to before me this 19th day of May, 1944.

(Seal) VIOLET NEUENBURG,  
Notary Public in and for the City and County of  
San Francisco, State of California.

My Commission Expires Jan. 3, 1947.

[Endorsed]: Filed T.C.U.S. May 24, 1944. [31]

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[Title of Tax Court and Cause.]

### ORDER

Under date of May 25, 1944, petitioner filed a motion for rehearing and reconsideration of the Court's opinion and decision in the above-entitled cause entered April 27, 1944. This motion was accompanied by an affidavit of petitioner's counsel and

also by a "Memorandum of Points and Authorities in Support of Motion for Rehearing and Reconsideration." Very careful consideration has been given to this motion and to the brief accompanying it. After due deliberation, it is

Ordered: That the motion by petitioner for rehearing and reconsideration of this Court's opinion and decision in the above-entitled cause entered April 27, 1944, be and the same is hereby denied.

(Signed) C. R. ARUNDELL  
Judge.

Dated: June 5, 1944. [65]

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[Title of Tax Court and Cause.]

#### STIPULATION

Whereas, the income tax return of Lenore S. Robinette for the period involved in the above entitled matter was filed with the Collector of Internal Revenue for the District of Florida, in which state Lenore S. Robinette was at that time a resident; and

Whereas, at all times since the commencement of the above entitled matter Lenore S. Robinette was and she now is an individual residing in the State of California; and

Whereas, Lenore S. Robinette intends to file a petition for review of the decision of the Tax Court of the United States in the above entitled matter;

It is hereby stipulated and agreed by and [66] between Lenore S. Robinette and the Commissioner

of Internal Revenue, by their respective attorneys, that the United States Circuit Court of Appeals for the Ninth Circuit is designated by said parties as the Circuit Court of Appeals wherein the decision of the Tax Court of the United States in the above entitled matter may be reviewed.

JESSE H. STEINHART

JOHN J. GOLDBERG

111 Sutter Street

San Francisco, California

Attorneys for Petitioner.

SAMUEL O. CLARK, JR.

Assistant Attorney General,

Attorney for Commissioner  
of Internal Revenue.

Dated: July 21, 1944.

[Endorsed]: Filed T. C. U. S. Aug. 30, 1944. [67]

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United States Circuit Court of Appeals  
for the Ninth Circuit

Docket No. 1176

LENORE S. ROBINETTE,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent.

PETITION FOR REVIEW OF DECISION OF  
THE TAX COURT OF THE UNITED STATES  
To the Judges of the United States Circuit Court of  
Appeals for the Ninth Circuit:

The above named petitioner hereby petitions for a review of the decision of The Tax Court of the United States and as a basis of her proceeding alleges as follows:

1. The petitioner is an individual whose residence is at 143 Isabella Avenue, Atherton, California. The return for the period here involved was filed with the Collector for the District of Florida.

2. The taxes in controversy are income taxes for the taxable period beginning February 1, 1939, and ending December 31, 1939, and the amount in controversy is Six Hundred Sixty-five Dollars and Ninety-two Cents (\$665.92). [68]

3. The facts involved are as follows:

(a) Petitioner was and she now is a shareholder in Metropolitan Properties Company, a California corporation, incorporated on November 21, 1924, with its principal place of business located in San Francisco, California. Cole-French Company was incorporated under the laws of the State of California in December, 1919, with its principal place of business in San Francisco, California, and was dissolved on December 24, 1936.

(b) On December 24, 1936, Metropolitan Properties Company was the sole stockholder of Cole-French Company. On December 24, 1936, Cole-French Company was dissolved in a complete liquidation carried out pursuant to the provisions of section 112 (b) (6) of the Revenue Act of 1936, under which no gain or loss to Metropolitan Properties Company was recognized. In connection with and as a part of the dissolution of Cole-French Com-

pany, Metropolitan Properties Company surrendered all of the stock of Cole-French Company to that corporation, and in cancellation of all of such stock Cole-French Company distributed to Metropolitan Properties Company, subject to liabilities, all of the assets of Cole-French Company.

(c) On December 24, 1936, just prior to the dissolution of Cole-French Company, Cole-French Company had earnings, profits and surplus of not more than Two Hundred Forty-four Thousand [69] Nine Hundred Sixty-eight Dollars and Sixty-nine Cents (\$244,968.69).

(d) On January 1, 1939, Metropolitan Properties Company had outstanding eleven thousand six hundred (11,600) shares of its capital stock of the par value of One Hundred Dollars (\$100.00) each. In 1939 the par value of said stock was reduced to Eighty Dollars (\$80.00) per share, and there was recorded on the books of Metropolitan Properties Company the amount of Two Hundred Thirty-two Thousand Dollars (\$232,000.00) designated "Reduction of Surplus Account". During the taxable year petitioner was the owner of eight hundred thirty-three and one-third (833-1/3) shares of the capital stock of Metropolitan Properties Company, which shares had an adjusted basis to petitioner of not less than Eighty Dollars (\$80.00) per share.

(e) During the taxable period Metropolitan Properties Company distributed One Hundred Ten Thousand Two Hundred Dollars (\$110,200.00) to its shareholders. Petitioner received distributions

from said corporation during said taxable period aggregating Seven Thousand Nine Hundred Sixteen Dollars and Sixty Cents (\$7,916.60). In connection with said distributions, petitioner was advised by Metropolitan Properties Company that Two Thousand Forty-seven Dollars and Sixty-three Cents (\$2,047.63), or 25.865% of said distributions was taxable income, and that Five Thousand Eight Hundred Sixty-eight Dollars and Ninety-seven Cents (\$5,868.97), constituting 74.135% of said distribution, was a distribution from the [70] capital of said corporation and not from earnings or profits of Metropolitan Properties Company. Pursuant to such advice, petitioner returned Two Thousand Forty-seven Dollars and Sixty-three Cents (\$2,047.63) as taxable income.

(f) Respondent determined that all of said distributions received by petitioner constituted taxable income and assessed a deficiency in federal income taxes for said taxable period in the amount of Six Hundred Sixty-five Dollars and Ninety-two Cents (\$665.92). In arriving at said deficiency respondent determined that prior to the distributions of Metropolitan Properties Company to its shareholders during the taxable period of One Hundred Ten Thousand Two Hundred Dollars (\$110,200.00) the earnings or profits of Metropolitan Properties Company available for the payment of dividends was Three Hundred Twenty-one Thousand Fifty-five Dollars and Twenty-one Cents (\$321,055.21). Respondent has conceded that said amount should be reduced to Two Hundred Eighty-three Thousand

Eight Hundred Eighty-three Dollars and Thirteen Cents (\$283,883.13). In determining the earnings or profits of Metropolitan Properties Company prior to the distributions during said taxable period, respondent included therein as earnings or profits of Metropolitan Properties Company the earnings or profits of Cole-French Company as of December 24, 1936, and just prior to the dissolution of Cole-French Company, in the amount of Two Hundred Forty-four Thousand Nine Hundred Sixty-[71] eight Dollars and Sixty-nine Cents (\$244,968.69).

5. That on or about April 5, 1943 petitioner filed a petition with The Tax Court of the United States for a re-determination of the deficiency asserted by respondent in the amount of Six Hundred Sixty-five Dollars and Ninety-two Cents (\$665.92), which petition alleged that respondent erred in ruling that petitioner's income should be increased by Five Thousand Eight Hundred Sixty-eight Dollars and Ninety-seven Cents (\$5,868.97), being the difference between the aggregate of distributions in the sum of Seven Thousand Nine Hundred Sixteen Dollars and Sixty Cents (\$7,916.60) received by petitioner from Metropolitan Properties Company during the taxable period, and the portion of such distributions which was taxable, to-wit: Two Thousand Forty-seven Dollars and Sixty-three Cents (\$2,047.63). Said proceeding was entitled "Lenore S. Robinette vs. Commissioner of Internal Revenue, Docket No. 1176." That on April 27, 1944 The Tex Court of the United States issued an opinion and decision in said proceeding that the deficiency in the amount

of Six Hundred Sixty-five Dollars and Ninety-two Cents (\$665.92) as determined by respondent was proper.

5. That within the time and in the manner provided by law and on the 25th day of May, 1944, petitioner filed with The Tax Court of the United States a motion for a rehearing and reconsideration of the opinion and decision of The Tax Court of the United States in said proceeding. On [72] June 5, 1944, The Tax Court of the United States made an order that the motion by petitioner for rehearing and reconsideration of said Court's opinion and decision in the said cause entered April 27, 1944, be denied.

6. Petitioner respectfully petitions for a review of said decision of The Tax Court of the United States on the ground that said decision is not in accordance with law in that The Tax Court of the United States erred in ruling that the earnings or profits of Metropolitan Properties Company were increased by the distribution in 1936 of the assets of Cole-French Company to Metropolitan Properties Company in complete liquidation under section 112 (b) (6) of the Revenue Act of 1936. Jurisdiction of this proceeding is conferred upon this Court by Subdivision (a) of Section 1141 (26 U.S.C.A.).

7. Venue of this proceeding has been conferred upon this Court by a stipulation in writing by and between the Commissioner of Internal Revenue and petitioner designating the United States Circuit Court of Appeals for the Ninth Circuit as the Circuit Court of Appeals wherein the decision of The Tax Court of the United States in said proceeding

may be reviewed. A copy of said written stipulation is attached hereto marked Exhibit "A" and incorporated herein and made a part hereof by reference.

Wherefore, petitioner, being without remedy in the premises except in this Court, prays this Court: [73]

(a) To review each and every part of the record in said proceeding before The Tax Court of the United States, and to review the decision of The Tax Court of the United States made and entered April 27, 1944, and to reverse and set aside in whole said decision.

(b) To issue forthwith its order to The Tax Court of the United States directing it to certify and file with the Clerk of this Court a transcript of the record upon which its decision, dated April 27, 1944, was made.

(c) To grant such other and further relief as to this Court shall seem meet and proper in the premises.

Dated August 24, 1944.

LENORE S. ROBINETTE

Petitioner.

JESSE H. STEINHART

JOHN J. GOLDBERG

Room 700, 111 Sutter Street

San Francisco, California

Attorneys for Petitioner. [74]

For Exhibit "A" see page 33.

State of California,  
City and County of San Francisco—ss.

Lenore S. Robinette, being first duly sworn, on oath deposes and says:

That she is the petitioner herein; that she has read the foregoing petition and knows the contents thereof and that the same is true of her own knowledge except as to the matters which are therein stated on information and belief, and as to those matters she believes it to be true.

LENORE S. ROBINETTE

Subscribed and sworn to before me this 24th day of August, 1944.

[Seal] VIOLET NEUENBURG

Notary Public in and for the City and  
County of San Francisco, State of  
California.

My Commission expires January 3, 1947.

(Affidavit of Service attached.)

[Endorsed]: Filed T.C.U.S. Aug. 30, 1944. [75]

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[Title of Tax Court and Cause.]

#### AGREED STATEMENT OF FACTS

It Is Hereby Stipulated and Agreed by and between Lenore S. Robinette and the Commissioner of Internal Revenue by their respective attorneys that for the purposes of this proceeding the following facts are true and correct and that the Court may

incorporate the same into its findings of fact, subject to the right of either party to introduce further evidence not inconsistent with the facts herein stipulated and to object to the relevance or materiality of any of such facts:

1. That petitioner is now and has been for several years last past a citizen and resident of the State of California and prior thereto and at the time of filing the return of income for the taxable year beginning February 1, 1939 and ending December 31, 1939 was a citizen and resident of the State of Florida; [78]
2. That Metropolitan Properties Company is now and at all of the times herein mentioned was a corporation duly created, organized and existing under the laws of the State of California, with its principal place of business in the City and County of San Francisco in said state; that said corporation was incorporated on November 21, 1924;
3. That at all of the times herein mentioned to and including December 24, 1936 Cole-French Company was a corporation duly created, organized and existing under and by virtue of the laws of the State of California, with its principal place of business in the City and County of San Francisco in said state; that Cole-French Company was incorporated in December 1919 and was duly and regularly dissolved on December 24, 1936;
4. That during the said taxable year beginning February 1, 1939 petitioner was a stockholder of Metropolitan Properties Company and as such stockholder received distributions from said cor-

poration aggregating \$7,916.60; that pursuant to advice from said corporation petitioner returned as taxable income \$2,047.63 of said distribution, being 25.865% of said distribution, and failed to return as taxable the remaining \$5,868.97 constituting 74.135% of said distribution; that petitioner's failure to include said sum of \$5,868.97 in taxable income returned by her for the taxable period involved was based on advice to her by said corporation that said sum was distributed to her from the capital of [79] the corporation and not from any profits, earnings or surplus of said corporation; that the Commissioner has determined that all of said distributions in the amount of \$7,916.60 constituted taxable income received by petitioner during the taxable period, and that there is a deficiency in Federal income tax due from petitioner for the taxable year in the sum of \$665.92; that if said sum of \$5,868.97 was taxable income of petitioner in said taxable period there is a deficiency in Federal income taxes paid by petitioner for said taxable period in the sum of \$665.92;

5. That at all of the times herein mentioned Metropolitan Properties Company had outstanding 11,600 shares of its capital stock; that said shares were originally of the par value of \$100 each; that during the year 1939 such par value was by way of amendment to the articles of incorporation reduced to \$80 per share and there was recorded on the books of said corporation an amount of \$232,000 designated "Reduction of Surplus Account;" that at all of the times herein mentioned petitioner owned and

held 833-1/3 shares of the capital stock of said corporation and that said shares had an adjusted basis in the hands of petitioner of not less than \$80 per share; that during 1939 Metropolitan Properties Company distributed to its stockholders \$116,000 of which \$5,800 was distributed on January 3, 1939 and the remaining \$110,200 was distributed during the taxable period here involved; [80]

6. That in arriving at the deficiency involved in this proceeding the Commissioner determined that as of December 31, 1939 and before giving effect to distributions to its shareholders in the sum of \$116,000 which Metropolitan Properties Company made during 1939, the earnings, profits and surplus of Metropolitan Properties Company available for the payment of dividends was \$321,055.21. The Commissioner concedes that this latter amount should be reduced to \$283,883.13 to give effect to a loss by Metropolitan Properties Company of \$37,172.08 arising from a sale of securities and not reflected in its income tax returns. Said amount of \$321,055.21 includes \$2,930.62 expended by Metropolitan Properties Company for its organization and not allowable as a deduction from its taxable income. In arriving at his determination of the amount of Metropolitan Properties Company's said earnings, profits and surplus in the amount of \$321,055.21 the Commissioner included therein the earnings, profits and surplus of Cole-French Company on December 24, 1936, as determined by the Commissioner. The Commissioner determined that Cole-French Company had earnings, profits and

surplus on December 24, 1936 of \$244,968.69. In arriving at his determination that Cole-French Company had earnings, profits and surplus on December 24, 1936 in said amount of \$244,968.69 the Commissioner considered as and included in such earnings, profits and surplus the amount of \$225,000 which had been debited to profit and loss account and credited to capital account on the books of Cole-French Company as of December 31, 1928, hereinafter referred to. Petitioner disputes the said determination of the Commissioner that the said amount of \$244,968.69 [81] included by him in the earnings, profits and surplus of Metropolitan Properties Company, as aforesaid, or the said amount of \$244,968.69, constitutes or at any time constituted, in whole or in part, earnings, profits or surplus of Metropolitan Properties Company, and petitioner further disputes the determination of the Commissioner that said amount of \$225,000 or any part thereof constituted earnings, profits or surplus of Cole-French Company when it was dissolved on December 24, 1936. Certain facts with respect to said item of \$225,000 are as follows:

(a) Immediately prior to December 31, 1928 Cole-French Company had issued and outstanding 2500 shares of its capital stock of the par value of \$100 per share. These shares were issued pursuant to a subscription agreement under which the shareholders paid to the corporation \$10 per share and agreed to pay the remaining \$90 per share in such amounts and at such times as called for by resolutions of the Board of Directors of Cole-French

Company. On December 27, 1928, Cole-French Company not having at any time called on its shareholders to pay additional amounts upon such subscription agreements, the Board of Directors of Cole-French Company adopted the following resolution:

“Resolved that the Secretary be authorized and instructed to make a journal entry as of December 31st, 1928, debiting the profit and loss account with \$225,000 and crediting the capital account with said sum of \$225,000 so that the credit to the capital stock account shall equal the par value of 2500 shares of stock issued and

“Further Resolved that the Secretary be authorized and instructed to certify upon the face of all outstanding certificates of capital stock that the same are now fully paid up.”

Following the adoption of said resolution and pursuant thereto, entries reflecting the same were made in the journal [82] of Cole-French Company as shown in the following journal entries of Cole-French Company for the month of December 31, 1928 and closing entries for the year 1928:

Revenue .....	\$ 15,539.01
Gain on sale of stocks .....	237,778.97
Interest received .....	118.31
Dividends received .....	5,059.37
Profit and Loss .....	258,495.66
Profit and Loss .....	45,622.30
Salaries .....	35,766.25
Miseellaneous expenses .....	5,952.60
Local taxes .....	711.76
Depreciation F & F .....	324.00
Interest paid .....	1,156.19
Loss on sale of stocks .....	1,711.50
Profit and Loss .....	212,873.36
Surplus .....	212,873.36
Earnings for the year 1928 .....	225,000.00
Surplus .....	225,000.00
Capital Stoek (paid in) .....	225,000.00

To make stoek "full paid" as per resolution by Board of Directors December 27, 1928.

At the time of the adoption of said resolution and prior to making the entries referred to, the books of Cole-French Company on December 31, 1928 recorded its assets, liabilities and net worth as follows: [83]

#### ASSETS

Office funds .....	\$ 25.00
Bank of California, N. A.....	21,008.48
Union Trust Co. .....	1,089.90
Union Trust Co.—Savings .....	1,895.72
Aecounts receivable .....	47,994.50
Notes receivable .....	2,250.00
Furniture & Fixtures .....	3,558.16
Depreciation .....	324.00
	3,234.16
Stocks and Bonds .....	342,385.93
Personal aecount .....	201.84
Advanees and deposits .....	31.27
	<u><u>\$420,116.80</u></u>

## LIABILITIES

Wm. J. Boyd .....	\$ 1,895.72
Loans payable—(Calif. Ink) .....	100,000.00
Notes payable—Bank of California .....	50,000.00
Capital stock issued .....	25,000.00
Surplus .....	30,347.72
Profit and Loss (1928) .....	212,873.36
	_____
	\$420,116.80
	_____

After such entries were made the books of Cole-French Company on December 31, 1928 recorded its assets, liabilities and net worth as follows:

## ASSETS

Office funds .....	\$ 25.00
Bank of California, N. A.....	21,008.48
Union Trust Co. .....	1,089.90
Union Trust Co.—Savings .....	1,895.72
Accounts receivable .....	47,994.50
Notes receivable .....	2,250.00
Furniture & Fixtures .....	\$3,558.16
Depreciation .....	324.00
	_____
Stocks and Bonds .....	342,385.93
Personal account .....	201.84
Advances and deposits .....	31.27
	_____
	\$420,116.80
	_____

[84]

## LIABILITIES

Wm. J. Boyd .....	\$ 1,895.72
Loans payable (Calif. Ink) .....	100,000.00
Notes payable—Bank of California.....	50,000.00
Capital stock issued .....	250,000.00
Surplus .....	18,221.08
	_____
	\$420,116.80
	_____

(b) At the time of the adoption of said resolution none of the stockholders of Cole-French Company reported any taxable income by reason of the adoption of said resolution or by reason of any steps taken pursuant thereto, nor was any taxable income, by reason thereof, included in their income by the Commissioner, but petitioner objects to the statement contained in this subdivision (b) and to its consideration or acceptance by the Court, on the ground that such statement is irrelevant and immaterial;

(c) At the time when Cole-French Company was dissolved, on December 24, 1936, Metropolitan Properties Company was the sole stockholder of Cole-French Company. Immediately following such dissolution and on December 24, 1936 Cole-French Company in complete liquidation and upon surrender and in cancellation of all of its shares of stock held by Metropolitan Properties Company distributed and transferred to Metropolitan Properties Company subject to the liabilities all of the assets of Cole-French Company. There was recorded on the books of Cole-French Company at the time of such dissolution and distribution assets and liabilities as [85] follows:

## ASSETS

Revolving Funds .....	\$ 25.00
Bank of California, N. A.....	13,803.77
Union Trust Company .....	22,993.04
Anglo California Trust Co.....	672.07
Accounts receivable .....	297,291.48
Notes receivable .....	800.00
Furniture & Fixtures .....	\$2,753.08
Less depreciation .....	2,112.00
	_____
Stocks and Bonds .....	674,647.32
Advances—Rodox .....	4,120.65
Deposit—Insurance .....	31.27
	_____
	\$ 1,015,025.68

## LIABILITIES

Suspense—Fortuna Mine .....	\$ 166.99
Capital Stock .....	1,020,000.00
Surplus (deficit) .....	5,141.31
	_____
	\$ 1,015,025.68

The aforesaid item of capital stock in the sum of \$1,020,000.00 included \$250,000.00 consisting of \$25,000.00 paid prior to December 31, 1928 on account of the purchase price of 2500 shares of the aggregate par value of \$250,000.00 and \$225,000.00 recorded as a debit to surplus and as a credit to capital stock on the books of Cole-French Company pursuant to the said resolution above quoted. Said 2500 shares of capital stock of Cole-French Company were at all times after December 31, 1928 carried on the books of Cole-French Company as a capital stock liability in the sum of \$250,000.00 and the said 2500 shares were at all times since

December 31, 1928 considered by Cole-French Company as fully paid shares.

(d) The distribution by Cole-French Company to [86] Metropolitan Properties Company on December 24, 1936 was in pursuance of the liquidation of a wholly owned subsidiary and was carried out pursuant to the provisions of Section 112(b)(6) of the Revenue Act of 1936 under which no gain or loss to Metropolitan Properties Company was recognized. The fair market value of the assets, less liabilities, received by Metropolitan Properties Company on said liquidation exceeded the adjusted basis of the stock of Cole-French Company in the hands of Metropolitan Properties Company on said date by not less than \$200,000, but during 1939 the fair market value of said assets still retained by Metropolitan Properties Company had declined by more than \$200,000.

JESSE H. STEINHART

JOHN J. GOLDBERG

111 Sutter Street, San Francisco, California

Attorneys for Petitioner.

J. P. WENCHEL - RHN

Chief Counsel Bureau of Internal Revenue, Attorney for Commission of Internal Revenue.

Dated: November 26, 1943.

[Endorsed]: Filed T.C.U.S. Nov. 26, 1943. [87]

Before The Tax Court Of The United States  
Docket No. 1176

LENORE S. ROBINETTE,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent.

## PROCEEDINGS

Room 401, Civic Auditorium,  
San Francisco, California,  
Friday, November 26, 1943  
10 o'clock a.m.

(Met pursuant to notice).

Before: Hon. C. R. Arundell, Judge.

## Appearances:

John J. Goldberg, Esq.,  
111 Sutter Street, San Francisco,  
California, Appearng for Petitioner.Harry R. Horrow, Esq.,  
Appearing for Respondent. [89]

The Clerk: Docket No. 1176, Lenore S. Robinette.

Mr. Horrow: Ready for respondent, your Honor.

The Court: Will you make a brief opening statement, please?

STATEMENT ON BEHALF OF THE  
PETITIONER

Mr. Goldberg: I represent the petitioner, and on behalf of the petitioner we have agreed with counsel

for the respondent upon the facts in this matter and ask leave to file now an agreed statement of facts. Do I understand that we file an original and a copy?

The Clerk: Yes, sir.

Mr. Goldberg: I will furnish the copy in a moment.

I understand your Honor desires an opening statement in connection with this matter?

The Court: Yes.

Mr. Goldberg: This appeal involves a small deficiency but it affects one of a number of stockholders who stand in the same position and we anticipate that whatever decision is finally reached in this matter would likewise affect the other stockholders.

In this particular case the deficiency that is claimed is \$665.92 and it is for the taxable period from February 1, 1939, to December 31, 1939. The petitioner, Lenore Robinette, is the owner of 833-1/3 shares of the [91] stock of Metropolitan Properties Company, a California corporation, and the issue is whether certain distributions made by that corporation during the taxable period were entirely from earnings and profits or were in part from capital. The corporation advised its stockholders that a certain percentage was from capital of the corporation, approximately 75 per cent.

In the year in question the corporation distributed \$116,000, of which the petitioner received \$7,916.60 during the taxable period, and returned as taxable \$2,047.63.

There isn't any substantial dispute between the parties as to the amount of earnings and profits of

Metropolitan Properties Company except for the effect, if any, of a dissolution of Cole-French Company, which was a wholly owned subsidiary of Metropolitan Properties, on December 24, 1936. At that time all of the assets, and there were no liabilities, of Cole-French Company were distributed to Metropolitan Properties Company.

The Commissioner and the petitioner have agreed for the purposes of this case that if the distribution of Cole-French Company vested any earnings or profits in Metropolitan Properties Company, then there were enough earnings and profits of Metropolitan with which to make these distributions taxable. The Commissioner has determined that Cole-French Company had \$244,968.69 as earned [92] surplus at the time of its dissolution. We do not agree with that figure, and in our judgment the figure, at the very best, giving the Commissioner the benefit of the issue that is here involved, would be approximately \$220,000.

**The Court:** Would that make any difference?

**Mr. Goldberg:** It would not make any difference for the purpose of this case, and particularly in view of the small deficiency involved here we do not intend to contest that matter although we believe that the petitioner's version of the figure is correct.

There are two issues, therefore, with respect to Cole-French Company: first, whether, if it had earnings and profits at the time of its dissolution, those earnings and profits are to be considered as such in the hands of Metropolitan Properties Company fol-

lowing the distribution and therefore available for dividends.

The other question is this: in order to have the \$244,000 or the \$220,000 in earnings at the time of its dissolution, we must consider that a sum of \$225,000 which Cole-French Company had capitalized in 1928 was still earnings and profits for the purpose of distribution at the time of its dissolution in 1936.

With respect to that item of \$225,000, briefly, the facts are that the Corporation when it was organized in 1924 issued 2,500 shares of stock under a subscription [93] agreement pursuant to which the stock holders paid \$10 per share and agreed to pay the remaining \$90 whenever called for by the Board of Directors. The Board of Directors did not make any call for the balance of the \$90, but in 1928, on December 27th, having more than enough earnings with which to meet or to match the \$225,000 unpaid on the stock, the Board of Directors adopted a resolution authorizing and directing the Secretary to make an entry transferring from profit and loss to capital stock the sum of \$225,000 and marking as fully paid the certificates representing the 2,500 shares of stock. From that time on the corporation carried this item of capital stock as \$225,000 instead of as \$25,000 and unpaid subscriptions of \$225,000.

Now, the Commissioner's contention is that that \$225,000 continued as distributable surplus of the Corporation at the time of its dissolution and likewise retained the same character in the hands of Metropolitan when these distributions were made in

1939. Were it not for these amounts of Cole-French Company which are claimed to be earnings and profits, it is undisputed that the earnings of Metropolitan Properties Company available for dividends in 1939 were somewhere between \$38,000 and \$39,000 as against an actual distribution of \$116,000.

The Court: Why wouldn't that sum of \$225,000 retain its character as earnings? [94]

Mr. Goldberg: Well, in our judgment it does not come within any of the categories which the statute has fixed or which the cases have described as continuing the character of those earnings. There are several—

The Court: They are earnings or profits since 1913, aren't they?

Mr. Goldberg: Yes, since 1913. The Corporation was organized in 1913.

The Court: Well, they do not, generally speaking, lose their character by simply issuing a stock dividend, do they?

Mr. Goldberg: We contend that this was not a stock dividend.

The Court: What was it?

Mr. Goldberg: Well, it was a transfer to surplus to make—to eliminate a liability of the stockholders for the remaining \$90 per share. It did not increase the par value of the outstanding shares but served to eliminate that liability so as to make the shares fully paid.

The Court: If it amounts to a stock dividend, what then? Is the Government right?

Mr. Goldberg: I would say that if it amounts to

a stock dividend there are statutes that now provide—and I am not too clear whether they so provided in 1928 or 1936—that now provide that a subsequent distribution [95] would be a distribution of earnings, but we do not believe the situation is parallel, and, in addition to which, our further contention is that regardless of what those earnings were in the hands of Cole-French Company at the time of the dissolution of Cole-French Company and the distribution of its assets to Metropoltan Properties Company, they did not retain their character as earnings, if they were earnings in the hands of Cole-French Company, but became mingled with the assets of Metropolitan Properties Company as to which a profit or loss would be recognized upon the disposition of those assets by Metropolitan Properties Company at an amount in excess of the base in the hands of the Cole-French Company, and the fact is—

The Court: Well, was this so-called liquidation something in the nature of a merger?

Mr. Goldberg: No; it was a dissolution under the laws of California pursuant to which the Corporation was dissolved, and, having no liabilities, its assets subject to its liabilities were distributed to its sole stockholder.

The Court: Wouldn't the stockholder at that time have a gain or loss?

Mr. Goldberg: No gain or loss was recognized in that transaction.

The Court: On what ground?

Mr. Goldberg: Under 112(b) of the Revenue Act of 1936. [96]

The Court: What does that provide?

Mr. Goldberg: Well, that provides in the event—substantially that in the event of liquidation of a wholly owned subsidiary, and provided that the distribution is made within a certain time, no gain or loss is recognized in that transaction and any subsequent gain or loss depends on a depreciation of the assets and a comparison with the base in the hands of the dissolved corporation.

The Court: It treats it as in the nature of a reorganization within the meaning of the statute?

Mr. Goldberg: Well, it is a situation where gain or loss is not recognized. It is not defined as a reorganization in that statute nor in any of the subsequent statutes.

The Court: Is it stipulated that the property passes from the Cole-French Company to the Metropolitan under the provisions of this 112(B)? I mean, it is such a transaction as would fall within that?

Mr. Goldberg: Yes, that is the stipulation: that was the nature of the transaction, and under it no gain or loss was recognized.

The Court: Hasn't it been held in similar circumstances as here that the surplus of the old company becomes the surplus of the new? It certainly has in merger [97] or consolidation cases.

Mr. Goldberg: It has been held in certain reorganization cases where you had a reorganization that came within the definition of the statute that

the surplus of the predecessor corporation continued its character as such in the hands of the successor corporation.

The Court: Why shouldn't that apply here?

Mr. Goldberg: Well, because it is a statutory matter. We don't believe that the statute covers this situation.

The Court: It is not statutory, is it, that says that surplus of the old company shall become the surplus of the new?

Mr. Goldberg: It was not statutory when the Sansome case was decided, and I happen to have come right behind the Sansome case in a case in the District Court here decided in favor of the taxpayer, and the Circuit Court of Appeals reversed the case because the Sansome case was just decided. That was the Kaufman case, and I felt at that time that the Sansome case was not correctly decided, and I think there have been a number of criticisms of that case and a limitation of it to its facts. So, where we have a different set of facts and no statute which says that those earnings retain their character after dissolution, it would require a new decision, one that has not been [98] rendered yet, in order to give those earnings the same character.

The Court: The Sansome case has had pretty wide application now through the years?

Mr. Goldberg: Yes. But, as some writers have pointed out, Courts have accepted the Sansome case in many situations where the facts were not parallel, and it has been so pointed out with respect to the case that I mentioned, where we felt that our facts

were not the same, and I think we can point out in the brief that we desire to file that there is a distinction.

The Court: Are there any cases outstanding that have been applied to facts like in your case?

Mr. Goldberg: No, I don't know of any facts that have been parallel to the case of ours. There are some statutory provisions that I wanted to discuss although I do not know that there are any cases that have applied to them, but I believe they are applicable.

The Court: Very well, Mr. Horrow?

#### STATEMENT ON BEHALF OF RESPONDENT

Mr. Horrow: May it please the Court, there are two issues presented for your Honor's determination:

First, to what extent did the earnings and profits of the Cole-French Company pass to the Metropolitan Properties Company and become the earnings and profits of [99] that Company on liquidation of Cole-French?

Secondly, to what extent the earnings and profits of Cole-French can be reduced by the transaction in 1928 whereby the stock of Cole-French was declared paid up and a debit was made to surplus of Cole-French and a credit to its capital account.

As to the first issue, there is no dispute, your Honor, that the liquidation of Cole-French was pursuant to the provisions of Section 112(b)6 of the Revenue Act of 1936 and that no gain or loss was recognized or was recognizable under those provi-

sions to Metropolitan Properties Company. It is our position that under the Sansome case, which has been applied very broadly to situations where assets do pass over and no gain or loss is recognized, that the earnings and profits of Cole-French passed to Metropolitan and became the earnings and profits of that company. The regulations so provide, and they have provided ever since Section 112(b) (6) came into the statute, that the earnings and profits of the company being liquidated become the earnings and profits of the corporation to which the assets of the liquidated company pass. Furthermore, there have been a number of statutory provisions enacted which assume or are based on the assumption that the earnings and profits of the liquidated corporation in a case where no gain or loss is recognized become the earnings and profits of [100] the corporation to which the assets pass.

Now, as to the second question, your Honor, there is direct authority that the transaction in 1928, whereby the books of Cole-French reflected a charge to surplus and a credit to capital stock, is a transaction which gave rise to a stock dividend. The case of Michaels against McLaughlin, decided by the District Court for the Northern District of California, dealt with a situation on all fours with the situation presented here, and in that case the Court held that the transaction gave rise to a stock dividend which was not taxable to the stockholders. The tax Court has followed the case of Michaels against McLaughlin and has cited it with approval. I believe that

this Court has passed on the very situation presented here as to the nature of the transaction.

Now, if a stock dividend was distributed in 1928, I believe the statute clearly provides that earnings and profits are not reduced by that dividend. During the taxable year in question Section 115(h) of the Code provided in effect that distributions of stock do not reduce earnings and profits available for the payment of dividends.

Now, if it should be held that the transaction did not give rise to a stock dividend, in any event our position is that earnings and profits were not reduced because there was not any taxable distribution for the year [101] 1928. So, whether it is called a stock dividend or simply regarded as a recapitalization, in no event was there a distribution of earnings and profits in 1928.

The Court: Well, just what is your 1928 transaction: a right to purchase stock without a down payment by the existing stockholders?

Mr. Horrow: Yes, your Honor. There was a—

The Court: Now, to follow that, then, there is an obligation of the stockholders to pay some additional sum?

Mr. Horrow: There is a contingent obligation, your Honor. It is recognized as the obligation of the stockholders under a contract. It is contingent and was so regarded in the Michaels case.

Now, there was never any call made by the Directors of Cole-French for the payment of the balance of the subscription price, so there never was fixed any obligation on their part to pay the balance of

that price. Under the resolution adopted by the Board of Directors appropriate book entries were made and the stock was declared to be paid up. So, I believe there is direct authority that that transaction gives rise to a stock dividend, and, under the statute, earnings and profits were not reduced.

The Court: Is that a purely unilateral act by the Corporation? [102]

Mr. Horrow: Yes, your Honor. There was no action taken by the stockholders, and the stipulation so discloses.

Now, as an alternative, we take the position that even if no stock dividend is deemed to have been distributed, nevertheless there wasn't any distribution of earnings and profits, and earnings and profits have not been reduced. It is our position that the mere book entries, and that is all the transaction amounted to, do not reduce the earnings and profits available for distribution. The stipulation discloses that at the time the entries were made there was sufficient earned surplus to cover the amount of the credit to capital account.

The Court: The stockholders agreed to pay a certain price for the stock?

Mr. Horrow: Well, they subscribed for the stock and they paid \$10 down, and the balance was payable when, as and if the Board of Directors should call on the stockholders to pay the remaining capital subscribed.

The Court: Is that the way it reads: that they are to pay it only if the Corporation calls for it?

Mr. Horrow: The stipulation reads that the

stockholders agreed to pay the remaining \$90 per share in such amounts and at such times as called for by resolutions of the Board of Directors of Cole-French Company, but it is alleged in the pleadings, and we have admitted the [103] allegation, that the balance of the subscription price was payable only when, as and if the Board of Directors should make a call, and that point was brought out in the Michaels case: that, no call having been made, there wasn't any fixed obligation on the part of the stockholders to pay the amount in question.

The Court: Has the stock been delivered to the stockholders?

Mr. Horrow: Yes, our Honor. The stipulation does not reveal that fact but I believe there is no dispute that they were stockholders.

The Court: I mean, these new shares of stock were delivered at the time the 10 per cent was paid?

Mr. Horrow: Yes, as far as I know the stockholders had the shares of stock and the books of the corporation recorded the fact that the shares of stock were paid up after these book entries were made in 1928 on the stock then outstanding.

The Court: Of course, that does not answer what I asked. I said: were the shares issued prior to this transaction in 1928 or were they not?

Mr. Horrow: Yes, the stock was issued at the time the down payment on the subscription price was paid.

The Court: Is that correct?

Mr. Goldberg: I think that is a fair [104] assumption from the stipulation. We did not ex-

pressly so state, but in the second part of the resolution it says:

"It is further resolved that the Secretary be authorized and instructed to certify upon the face of all outstanding certificates of stock that the same are now fully paid up," from which I think it can be assumed on the face of the stipulation that those certificates had been issued and were in the hands of the stockholders.

The Court: All right. Do you want to file briefs under the rule?

Mr. Goldberg: I would like to file a brief, your Honor. I don't recall now how much time we would have.

The Court: 45 days.

Mr. Goldberg: That is satisfactory.

Would that be an opening brief?

The Court: They will be simultaneous briefs and you can have 20 days for a reply.

The Clerk: That will be January 10th for the opening briefs and January 31st for the reply briefs.

(Whereupon, at 10:30 a.m., the hearing in the above entitled matter was closed.) [105]

[Title of Tax Court and Cause.]

CERTIFICATE

I, B. D. Gamble, clerk of The Tax Court of the United States do hereby certify that the foregoing pages, 1 to 109, inclusive, contain and are a true copy of the transcript of record, papers, and proceedings on file and of record in my office as called for by the Praeclipe in the appeal (or appeals) as above numbered and entitled.

In testimony whereof, I hereunto set my hand and affix the seal of The Tax Court of the United States, at Washington, in the District of Columbia, this 17th day of October, 1944.

[Seal]

B. D. GAMBLE

Clerk, The Tax Court of the  
United States

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[Endorsed]: No. 10908. United States Circuit Court of Appeals for the Ninth Circuit. Lenore S. Robinette, Petitioner, vs. Commissioner of Internal Revenue, Respondent. Transcript of the Record. Upon Petition to Review a Decision of The Tax Court of the United States.

Filed: October 31, 1944.

PAUL P. O'BRIEN,  
Clerk of the United States Circuit Court of Appeals for the Ninth Circuit.

United States Circuit Court of Appeals  
for the Ninth Circuit

No. 10908

LENORE S. ROBINETTE,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent.

STATEMENT OF POINTS TO BE RELIED ON  
IN THIS APPEAL AND DESIGNATION  
OF PORTIONS OF RECORD NECESSARY  
FOR CONSIDERATION THEREOF

To the Judges of the United States Circuit Court  
of Appeals for the Ninth Circuit and to the  
Clerk of Court:

Now comes the petitioner in the above entitled  
and numbered proceeding and pursuant to Sub-  
division (6) of Rule 19 of the Rules of Practice of  
this Court files with the Clerk of Court her state-  
ment of the points on which she intends to rely on  
the appeal and designates the parts of the record  
which she thinks necessary for the consideration  
thereof.

1. The legal question involved in this proceed-  
ing is whether upon the liquidation in 1936 of a  
subsidiary corporation pursuant to Section 112(b)  
(6) of the Revenue Act of 1936 the earnings and  
profits of the liquidated subsidiary became the earn-  
ings and profits of the parent corporation.

2. The Tax Court of the United States based its decision that upon such liquidation the earnings and profits of the subsidiary corporation became the earnings and profits of the parent corporation upon *Commissioner vs. Sansome* (2 Cir. 1932) 60 Fed. (2d) 961, certiorari denied 287 U. S. 667, and succeeding cases, particularly *Estate of Howard H. McClintic* (1942) 47 B.T.A. 188, upon Section 115(h) of the Revenue Act of 1936 as amended in 1938, and upon Article 115-11 of Regulations 94 accompanying the Revenue Act of 1936.

3. Petitioner contends that the decision of the Tax Court of the United States is not in accordance with law and is erroneous for the following reasons:

(a) The principle of *Commissioner vs. Sansome*, supra, dealt exclusively with transfers to a corporation in connection with a reorganization and is not applicable to the liquidation of a subsidiary corporation. Prior to the present decision the *Sansome* rule had not been applied to a corporate liquidation not a part of a reorganization. The facts in *Estate of Howard H. McClintic*, supra, were not the same as in the case at bar and therefore such case is not controlling here.

(b) The question of the extent to which the principle of *Commissioner vs. Sansome*, supra, should be applied was before Congress in the preparation of the Revenue Act of 1936 and at that time Congress by means of Section 115(h) of said Act determined to limit the application of the principle of *Commissioner vs. Sansome*, supra, to tax free

reorganizations and not to extend the same to liquidations of subsidiaries as was subsequently done by the amendment of Section 115(h) in the Revenue Act of 1938.

(c) Since the Sansome rule as enacted by Congress in Section 115(h) of the Revenue Act of 1936 did not apply to distributions of money or property in connection with a complete liquidation under Section 112(b)(6) of the Revenue Act of 1936, Article 115-11 of Regulations 94 insofar as it purported to prescribe a rule that a distribution of money or property in a complete liquidation to a distributee corporation increased the earnings or profits of said corporation was without statutory authority.

(d) The 1938 amendment to Section 115(h) of the Revenue Act of 1936, extending the Sansome rule to apply to distributions of money or property in connection with a complete liquidation under Section 112(b)(6) of the Revenue Act of 1936 has been expressly held by the Supreme Court of the United States to have no effect on liquidations in 1936 and the attempt of the Treasury Department in Regulations 94, Article 115-11 to apply the principle of the Sansome case as set forth in Section 115(h) of the Revenue Act of 1936 to the liquidation of subsidiaries was unauthorized and has been so held by the courts.

4. The parts of the record necessary for the consideration of the points relied upon by petitioner are as follows:

- (a) Docket entries of proceedings before The Tax Court of the United States;
- (b) Pleadings before The Tax Court of the United States;
- (c) Findings of fact, opinion and decision of The Tax Court of the United States;
- (d) Order of The Tax Court of the United States dated June 5, 1944, on the motion by petitioner for rehearing and reconsideration of The Tax Court's opinion and decision entered April 27, 1944;
- (e) Motion by petitioner for rehearing and reconsideration;
- (f) Petition for review;
- (g) Agreed statement of facts;
- (h) Transcript of proceedings before The Tax Court of the United States.

Respectfully,

JESSE H. STEINHART

JOHN J. GOLDBERG

111 Sutter Street

San Francisco, California

Attorneys for Petitioner.

Dated: November 2nd, 1944.

(Affidavit of Service attached.)

[Endorsed]: Filed Nov. 3, 1944. Paul P.  
O'Brien, Clerk.

No. 10,908

IN THE

**United States Circuit Court of Appeals**  
For the Ninth Circuit

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LENORE S. ROBINETTE,

*Petitioner,*

vs.

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

---

**BRIEF FOR PETITIONER.**

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JESSE H. STEINHART,

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111 Sutter Street, San Francisco 4, California,

*Counsel for Petitioner.*

**FILED**

DEC 27 1944

**PAUL P. O'BRIEN,**  
CLERK



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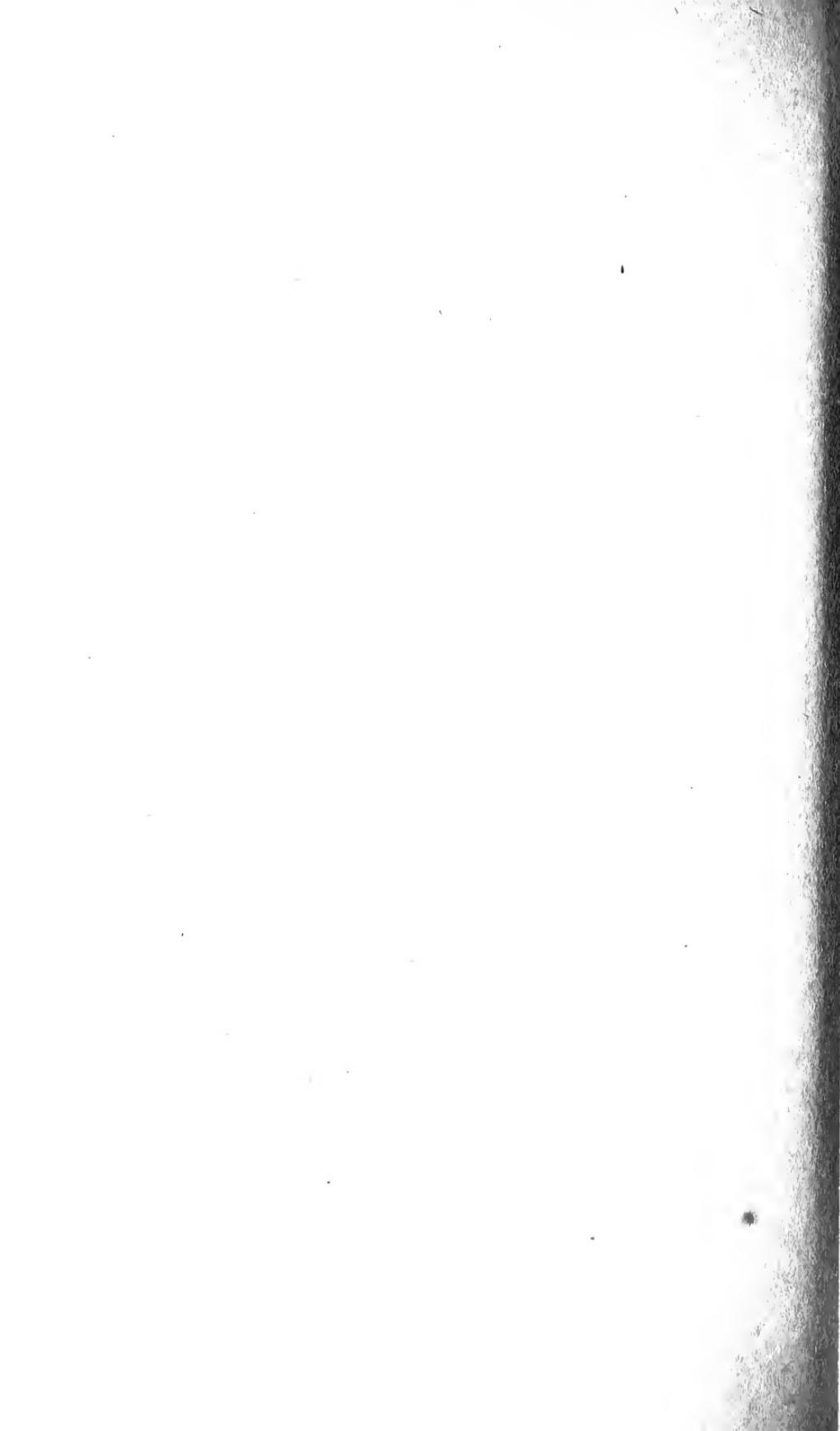
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No. 10,908

IN THE

**United States Circuit Court of Appeals  
For the Ninth Circuit**

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LENORE S. ROBINETTE,

*Petitioner,*

VS.

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

---

**BRIEF FOR PETITIONER.**

---

This is a petition for review of a decision of The Tax Court of the United States. The taxes in controversy are income taxes for the taxable period beginning February 1, 1939 and ending December 31, 1939. The deficiency asserted by respondent amounts to \$665.92 and this is the amount of tax in controversy.

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**BASIS OF JURISDICTION OF THE TAX COURT OF THE UNITED STATES AND BASIS OF JURISDICTION AND VENUE OF THE UNITED STATES CIRCUIT COURT OF APPEALS.**

Jurisdiction of The Tax Court of the United States arises under 26 U.S.C.A. § 272 and upon timely compliance by petitioner with the provisions of law and

the rules of The Tax Court of the United States issued under 26 U.S.C.A. § 1111. The notice of deficiency in income taxes for the taxable year involved was mailed by respondent to petitioner on January 9, 1943. (R.\* p. 9.) Petitioner filed a petition with the Tax Court for redetermination of the asserted deficiency in income taxes set forth in said notice of deficiency on April 5, 1943. (R. p. 9.) On April 27, 1944 the Tax Court issued an opinion and decision in said proceeding that the deficiency in income taxes in the amount of \$665.92, as determined by the respondent, was proper. (R. pp. 14-22.) On May 24, 1944 petitioner filed with the Tax Court a motion for rehearing and reconsideration of its opinion and decision in said proceeding. (R. pp. 22-32.) On June 5, 1944 the Tax Court made an order denying said motion. (R. p. 32.)

The jurisdiction of the United States Circuit Court of Appeals for the Ninth Circuit arises under 26 U.S.C.A. § 1141(a) and upon timely compliance by petitioner with the provisions of law and rules of Court issued under 26 U.S.C.A. § 1141(c) (2). On August 31, 1944 petitioner filed with the Tax Court a petition for review of its decision by the United States Circuit Court of Appeals for the Ninth Circuit. (R. pp. 34-40.) Venue of said proceeding is conferred upon this Court by a stipulation in writing between the respondent and petitioner designating this Court as the circuit court of appeals wherein the decision of the Tax Court in said proceeding might be reviewed. (R. pp.

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\*Refers to printed Transcript of Record.

33-34.) Said stipulation was filed with the Tax Court on August 30, 1944. (R. p. 34.)

On September 28, 1944, pursuant to Rule 75 of the Rules of Civil Procedure of the District Courts of the United States, petitioner served upon respondent and filed with the clerk of the Tax Court a designation of portions of record, proceedings and evidence to be contained in the record on appeal in this proceeding and to be filed with this Court. (R. p. 3.) On October 6, 1944 this Court made an order extending the time within which to file the record on appeal in this proceeding to and including November 10, 1944. A certified copy of said order was filed with the Tax Court on October 11, 1944. (R. p. 3.) Thereafter the clerk of the Tax Court transmitted the transcript of record on appeal and said transcript of record was received and filed by the clerk of this Court on October 31, 1944. (R. p. 66.)

Petitioner served upon respondent and on November 3, 1944 filed with the clerk of this Court a statement of points to be relied on in this appeal and designation of portions of record necessary for consideration thereof. (R. pp. 67-70.)

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#### **STATEMENT OF THE CASE.**

This case involves the legal question whether upon the liquidation in 1936 of a subsidiary corporation pursuant to the provisions of section 112(b) (6) of the Revenue Act of 1936, the undistributed earnings

or profits of the subsidiary corporation (accumulated after February 28, 1913, and not distributed up to the time of the distribution of its assets in complete liquidation under which no gain or loss to the parent was recognized) may be included in determining whether cash distributions made by the parent corporation in later years to its shareholders were taxable in full as dividends paid out of *its* earnings and profits within the meaning of section 115(a) of the Internal Revenue Code.

The findings of fact of the Tax Court were based upon an agreed statement of facts filed with that Court. (R. pp. 41-51.) The pertinent portion of the facts so found are as follows:

Petitioner is an individual residing in the State of California. During the year 1939 petitioner owned 833½ shares of stock of Metropolitan Properties Company (hereinafter referred to as Metropolitan), a California corporation, incorporated November 21, 1924. Said shares had an adjusted basis to petitioner of not less than \$80.00 per share.

Cole-French Company was incorporated under the laws of the State of California in December, 1919. On December 24, 1936 Metropolitan was the sole stockholder of Cole-French Company. On that date Cole-French Company was dissolved in a complete liquidation carried out pursuant to the provisions of section 112(b) (6) of the Revenue Act of 1936, under which no gain or loss to Metropolitan was recognized. Immediately prior to its complete liquidation on Decem-

ber 24, 1936 Cole-French Company had undistributed earnings and profits amounting to \$244,968.69. Immediately following the dissolution of Cole-French Company, Metropolitan surrendered all of the stock of Cole-French Company to that corporation and in cancellation of all of such stock Cole-French Company distributed to Metropolitan, subject to the liabilities, all of the assets of Cole-French Company. The fair market value of the assets less liabilities received by Metropolitan exceeded at the time of receipt the adjusted basis of the stock of Cole-French Company in the hands of Metropolitan by not less than \$200,000, but during 1939 the fair market value of those assets, still retained by Metropolitan, had declined by more than \$200,000.

During the taxable period here involved Metropolitan distributed \$110,000 to its shareholders. Petitioner received distributions from Metropolitan during the taxable period aggregating \$7916.60. Petitioner returned 25.865% of that amount or \$2047.63 as taxable income. The return was based upon advice from the corporation that of the total distribution to her, \$5868.97 or 74.135%, was a distribution from capital and not from its earnings, profits or surplus.

Respondent determined that all of said distributions received by petitioner constituted taxable income and assessed a deficiency of \$665.92. In arriving at said deficiency respondent determined that prior to the distributions of \$110,200 by Metropolitan to its shareholders during the taxable period the earnings or profits of Metropolitan available for the payment of

dividends was \$283,883.13. In determining the earnings or profits of Metropolitan prior to the distributions during the taxable period here involved, respondent included as earnings or profits of Metropolitan the accumulated earnings and profits of Cole-French Company as of December 24, 1936 in the amount of \$244,968.69.

The Tax Court affirmed the determination of respondent that upon the complete liquidation of Cole-French Company in 1936 the earnings and profits of that company should be included in determining whether the cash distributions of Metropolitan in 1939 were taxable in full as dividends paid out of its earnings and profits within the meaning of section 115(a) of the Internal Revenue Code.

The Tax Court based its decision upon *Commissioner v. Sansome* (2 Cir., 1932), 64 Fed. (2d) 931, certiorari denied, 287 U.S. 667, 53 S. Ct. 291, 77 L. Ed. 575, and succeeding cases, particularly *Estate of Howard H. McClintic* (1942), 47 B.T.A. 188.

Prior to the decision of the Tax Court in this case the *Sansome* rule had been applied only to transfers of assets to a corporation in connection with a reorganization and the cases cited by the Tax Court in support of its decision dealt with the application of the rule to that precise situation. The case at bar is the only case in which the *Sansome* rule was applied to an isolated corporate liquidation having no connection with reorganization proceedings, a situation patently different from a corporate liquidation in connection with a plan of reorganization whereby stock

of a predecessor corporation is acquired by a new or successor corporation *in exchange for its own stock* with a purpose of obtaining the assets in liquidation of the predecessor corporation.

The *Sansome* case and the principle of law enunciated therein is not applicable to and in any event is not determinative of the question here involved. Moreover, the Tax Court erred in extending the *Sansome* rule to embrace the isolated liquidation in 1936 of a subsidiary, not a part of a reorganization, and adopting a rule of law in conflict with the intent of Congress as expressed in section 115(h) of the Revenue Act of 1936. The question of the extent to which the *Sansome* rule should be applied was before the Congress in the preparation of the Revenue Act of 1936 and at that time Congress by means of section 115(h) of said Act determined to limit the application of the principle of *Commissioner v. Sansome, supra*, to tax-free reorganizations and not to extend the same to embrace isolated liquidations of subsidiaries having no connection with reorganization proceedings and not involving exchanges or distributions of stock or securities of the so-called parent corporation as was subsequently done by the amendment of section 115(h) in the Revenue Act of 1938.

It is submitted therefore that the *Sansome* rule was not applicable to a liquidation in 1936 of a subsidiary under section 112(b) (6) of the Revenue Act of 1936 and that the 1938 amendment to section 115(h) was not and could not be made retroactive.

**ARGUMENT.**

THE SANSOME CASE AND SUCCEEDING CASES DEALT EXCLUSIVELY WITH TRANSFERS TO A CORPORATION IN CONNECTION WITH A REORGANIZATION AND PRIOR TO THE PRESENT DECISION THE DOCTRINE OF INHERITED EARNINGS HAD NOT BEEN APPLIED TO AN ISOLATED CORPORATE LIQUIDATION NOT A PART OF A REORGANIZATION. BY CODIFYING THE SANSOME RULE AS THERETOFORE APPLIED IN SECTION 115(h) OF THE REVENUE ACT OF 1936 WITHOUT ENLARGING THE RULE TO APPLY TO CORPORATE LIQUIDATIONS UNDER SECTION 112(b) (6), CONGRESS MUST HAVE INTENDED NOT TO MAKE THE SANSOME RULE APPLICABLE TO A LIQUIDATION IN 1936 UNDER SECTION 112(b)(6). THE 1938 AMENDMENT TO SECTION 115(h) MAKING THE SANSOME RULE APPLICABLE TO LIQUIDATIONS UNDER 112(b) (6) COULD NOT BE APPLIED RETROACTIVELY TO A 1936 LIQUIDATION OF A SUBSIDIARY CORPORATION.

(a) **The origin and scope of the Sansome rule.**

The *Sansome* case involved a transfer of assets in a tax-free reorganization and did not involve the liquidation of a subsidiary corporation. In that case in 1921 Corporation A transferred all of its *assets* subject to liabilities to newly created Corporation B with additional charter powers in exchange for stock of Corporation B in a non-taxable corporate reorganization under section 202(c) (2) of the Revenue Act of 1921. The stock of Corporation B was distributed to the shareholders of Corporation A, that corporation being thereupon dissolved. After the reorganization the shareholders of Corporation B were the identical persons who had been shareholders of Corporation A with the same proportionate interest in said corporations. Prior to the reincorporation, Corporation A had a large earned surplus available for dividends,

and if Corporation A had made distributions, such distributions would have been received by the shareholders as taxable dividends. Corporation B operated without profit for little more than a year. It then dissolved and in 1923 made distributions in liquidation to said shareholders. Section 201 of the Revenue Act of 1921 which dealt with distributions from earnings or profits and distributions in liquidation, unlike the present statute, taxed such liquidation distributions as dividends to the extent of the earnings or profits of the corporation being liquidated.

The Commissioner treated these distributions as dividends. The taxpayer (a shareholder) contended that the distributions did not constitute taxable dividends since Corporation B had no earnings and profits of its own available for dividends and claimed the right to apply the payments to amortize his cost and pay a tax upon only so much as exceeded his cost. The Board of Tax Appeals held that the distributions were not dividends because not made out of the earnings or profits of Corporation B. The Circuit Court of Appeals reversed. The Board of Tax Appeals determined and the Court conceded that the issuance of stock by Corporation B in exchange for the assets of Corporation A was a capital transaction and that ordinarily subsequent distributions by Corporation B would have been deemed to be distributions of capital. Although Corporation A and its shareholders realized gain or loss upon the exchanges, the Court pointed out that under section 202(c) (2) of the Revenue Act of 1921, such gain or loss was not recognized for income tax

purposes. The Court therefore held that section 202 (c) (2) of the Revenue Act of 1921 should be read as a gloss on section 201 of the Revenue Act of 1921 and held that since the disposition of assets by Corporation A and the exchange of stock by the shareholders did not result in the recognition of gain or loss to Corporation A or to its shareholders under section 202(c) (2) the earnings or profits of Corporation A remained for purposes of distribution, earnings or profits of its successor, Corporation B, in liquidation, under section 201.

Judge Learned Hand, speaking for the Court, stated the Court's holding as follows (60 Fed. (2d) 931 at page 933) :

"\* \* \* we hold that a corporate reorganization which results in no 'gain or loss' under section 202(c) (2) \* \* \* does not toll the company's life as a continued venture under section 201, and that what were 'earnings or profits' of the original, or subsidiary, company remain, for purposes of distribution, 'earnings or profits' of the successor, or parent in liquidation."

Since the *Sansome* case involved an exchange in reorganization effected merely to secure additional charter powers with assets, liabilities and stockholders unchanged and did not involve the liquidation of a subsidiary corporation the case can hardly be construed as holding that the principle therein enunciated applies to an isolated liquidation of a subsidiary, not a part of a reorganization.

While it is true, as observed by the Tax Court (R. p. 15), that the doctrine of inherited earnings established in the *Sansome* case has been applied in a variety of circumstances, the application of the doctrine has always been restricted to a factual situation involving a non-taxable reorganization wherein assets of a predecessor corporation were transferred to a successor corporation, the shareholders of the predecessor corporation exchanging stock in such corporation for stock in the successor corporation.

*United States v. Kauffman* (9 Cir., 1933), 62 Fed. (2d) 1045;  
*Helen V. Crocker* (1934), 29 B.T.A. 773;  
*Murchison's Estate v. Commissioner* (5 Cir., 1935), 76 Fed. (2d) 641;  
*Harter v. Helvering* (2 Cir., 1935), 79 Fed. (2d) 12;  
*Reed Drug Co. v. Commissioner* (6 Cir., 1942), 130 Fed. (2d) 288, affirming (1941) 44 B.T.A. 573.

And the Circuit Court of Appeals for the Third Circuit has recently refused to extend the *Sansome* doctrine to a transfer of corporate assets which, while constituting a tax-free reorganization within the meaning of the Revenue Act, nonetheless was atypical in that it involved the introduction of new capital and new stockholders into the corporate picture with consequent changes in the proportionate interest of the old stockholders in the enterprise.

*Campbell v. United States* (3 Cir., 1944), 144 Fed. (2d) 177.

The Tax Court in its opinion indicates that the rule of the *Sansome* case is equally applicable to an isolated liquidation of a subsidiary corporation, not a part of a reorganization, upon the basis of the decision in *Estate of Howard H. McClintic* (1942), 47 B.T.A. 188. It appears, however, from a reading of the opinion in the *McClintic* case that no new principle was therein announced and that the factual situation there involved is unlike that of this case but is indistinguishable from the situation presented in the *Sansome* case and succeeding cases.

The *McClintic* case involved the acquisition in 1926 by McClintic-Marshall Corporation, a new corporation hereinafter referred to as "McClintic-Marshall", of all the outstanding capital stock of Construction Co., the old corporation, by issuing therefor directly to the stockholders of Construction Co. a like number of its own shares in a non-taxable reorganization within the meaning of section 203(b) of the Revenue Act of 1926. Thereafter and in *what was stipulated to be a part of the same tax-free reorganization*, McClintic-Marshall effected a complete liquidation of Construction Co. so that after the reorganization the new corporation possessed the assets of the old corporation and the shareholders of the new corporation were identically the same persons as the shareholders of the old corporation. In the *McClintic* case the taxpayer contended that McClintic-Marshall not only did not inherit the earnings or profits of Construction Co. but actually realized a loss on the transaction. The Tax Court disposed of this contention by pointing out that in the

type of reorganization there involved the successor corporation never realizes profit or loss nor is any profit or loss recognized to such successor corporation, at page 198, as follows:

"McClintic-Marshall appears to have acquired all of the stock of the Construction Co., and after becoming the owner of the stock, has effected a complete liquidation of Construction Co. by eventually transferring all of the assets of Construction Co. to itself. It thus received a total of \$65,000,000 worth of net assets. Obviously, it has had no loss. It got exactly what it set out to get and has paid for it in its own stock, which stock, at best, was not worth more than \$65,000,000. \$65,000,000 paid out and \$65,000,000 received back results in neither gain nor loss. Thus, actually, McClintic-Marshall had no loss whatsoever upon the acquisition of the assets of the Construction Co. nor upon its liquidation."

It is to be noted that the facts of the *McClintic* case different from the facts of the *Sansome* case only in that in the *McClintic* case the new or successor corporation issued its stock directly to the outstanding stockholders of the old or predecessor corporation in exchange for the stock of the predecessor corporation as a part of a plan of reorganization whereby the successor corporation obtained the assets in liquidation of the predecessor corporation.

In *George Whittell & Co.* (1936), 34 B.T.A. 1070, the Board of Tax Appeals held that a transaction like that involved in the *McClintic* case was a tax-free reorganization under section 112(i) (1) of the Reve-

nue Act of 1928 and was completely analogous to a reorganization like that involved in the *Sansome* case wherein the successor corporation first acquired for its stock the assets of the predecessor corporation and then as a final step in the reorganization plan the predecessor corporation exchanged with its own stockholders the stock of the successor corporation for its own stock. In the *Whittell* and *Sansome* cases as a part of a tax-free reorganization, the successor corporations obtained the assets of the predecessor corporations and the stockholders of the predecessor corporations became stockholders in the successor corporation.

In view of the holding in the *Whittell* case and the stipuation in the *McClintic* case that the liquidation of the subsidiary was a part of the tax-free reorganization, the Court in the *McClintic* case correctly held that the doctrine of inherited earnings established in the *Sansome* case was equally applicable to a non-taxable *reorganization* when the transaction involves the acquisition of the stock of the old corporation by the new corporation in exchange for the stock of the new corporation followed by the complete liquidation of the old corporation as a part of the same non-taxable reorganization, as it is in those instances involving the direct acquisition by the new corporation of the assets of the old corporation and the issuance of stock of the new corporation to the shareholders of the old corporation.

The facts of the instant case are therefore no more analogous to the relevant facts of the *McClintic* case than they are to those of the *Sansome* case.

The isolated liquidation of a corporation, not in connection with a reorganization, presents a factual situation entirely different from that involved in a transfer of corporate assets in connection with a reorganization. In the case of a transfer of assets in a reorganization upon a disposition of its assets the *predecessor* or *transferor* corporation realizes a gain or loss which is unrecognized at the time of the transfer in reorganization. For that reason in the *Sansome* case the Court held that the transferee or successor corporation inherited the earnings and profits of the old corporation to which no gain or loss was recognized. But, in the case of an isolated liquidation, not in connection with a reorganization, the liquidated corporation never realizes gain or loss nor is gain or loss *ever* recognized to that entity. The gain or loss, if any, is realized by the stockholder who turns in his stock. The stockholder, however, is not taxable upon the earnings and profits of the liquidated corporation as such. The *Sansome* and *McClintic* cases were not concerned with the isolated liquidation of a subsidiary corporation not connected with a reorganization and the question whether if the *distributee* corporation received assets in an isolated tax-free liquidation it inherited the earnings of the liquidated corporation was not involved in those cases. In the *Sansome* and *McClintic* cases the distributee corporation was deemed to have issued its stock for the assets so that such corporation could not have realized profit or loss on the transaction. The *Sansome* rule has been applied only in connection with transfers of corporate assets.

as a part of a tax-free corporate reorganization wherein the *transferor* corporation realized gain or loss which was unrecognized.

Had the complete liquidation of Cole-French Company occurred prior to January 1, 1936, the gain or loss to Metropolitan would have been recognized but Metropolitan would not have been taxed upon the earnings and profits of Cole-French as such. The liquidation distribution to Metropolitan would have been treated as full payment for the stock of Cole-French Company held by Metropolitan and Metropolitan would have had a recognized gain of not less than \$200,000. At the same time Metropolitan would have acquired a stepped-up basis equal to the fair market value of the assets received which basis would constitute a tax benefit upon ultimate disposition of the assets. Likewise any gain to Metropolitan would have increased its earnings and profits but the fact that Cole-French Company may have had earnings and profits would have been entirely irrelevant. The tax of Metropolitan would have been the same regardless of whether the earnings and profits account of Cole-French Company had a surplus or a deficit. What then was the purpose and effect of the enactment of Section 112(b) (6) of the Revenue Act of 1936?

- (b) The purpose of section 112(b) (6) of the Revenue Act of 1936 was to encourage the simplification of corporate structures and not to discriminate against corporations receiving property in liquidation as compared with shareholders other than corporations. The effect of said section was merely to postpone the recognition of gain or loss to the distributee corporation until disposition in a taxable transaction of the property received.

In order to facilitate the simplification of corporate structures Congress enacted section 110 of the Revenue Act of 1935 which amended the Revenue Act of 1934 by adding section 112(b) (6) thereto, effective for taxable years beginning after December 31, 1935. (See Senate discussion, Cong. Rec. Vol. 80, p. 8799, Seidman's *Legislative History of Federal Income Tax Laws, 1938-1961*, p. 242.) Although the 1935 law never became operative, section 112(b) (6) of the Revenue Act of (June 23) 1936 being substituted therefor before the completion of any of such taxable years, the 1935 Act is of historical importance in connection with an understanding of the purpose and effect of section 112(b) (6) of the Revenue Act of 1936.

The 1935 Act provided that no gain or loss should be recognized upon the receipt by a corporation of property or money in liquidation of another corporation if the distributee corporation owned at least 80% of the voting stock of such other corporation. Since such liquidations were to be treated as tax-free exchanges, section 113(a) (6) of the Revenue Act of 1934 prescribed that the basis of such property to the parent corporation was to be the substituted basis of the parent's investment in the subsidiary corporation.

The report of the Conference Committee (74th Cong., 1st Sess., H. Rept. 1885, Seidman's *Legislative History of Federal Income Tax Laws, 1938-1861*, p. 292) indicates that the purpose and effect of the 1935 Act was merely to postpone the recognition of gain or loss on the property received in complete liquidation of a subsidiary until the property received on liquidation was ultimately disposed of as appears from the following example set forth in the Conference Committee Report (Seidman, *supra*, p. 293) :

“Case No. 1

Corporation A paid \$100,000 for the stock of Corporation B. It liquidates Corporation B and receives on liquidation property worth \$200,000 at the date of liquidation. Corporation A has realized a gain of \$100,000 from the liquidation, which under the amendment is not recognized. However, the basis of Corporation B's property in the hands of Corporation A will be not \$200,000, the value at the time of liquidation, but \$100,000, the amount Corporation A paid for Corporation B's stock. Corporation A subsequently sells the property it acquired from Corporation B on liquidation for \$200,000. Corporation A will be required to pay a tax in the year of sale on a \$100,000 gain.”

The foregoing example indicates that under the 1935 Act the earnings and profits of the subsidiary corporation were not to be deemed to be distributed to the parent corporation as earnings and profits but that there was to be merely a postponement of the recognition of gain or loss on the transaction until ultimate

disposition by the parent corporation of the assets of the subsidiary corporation, at which time proper adjustment would be made in the earnings and profits account of the parent.

Since a corporation upon liquidation never realizes gain or loss and its shareholders are never taxable upon the earnings and profits of the liquidated corporation upon their distribution in liquidation, distributions in liquidation are only deceptively similar to exchanges in reorganization. It is purely artificial to attribute to a corporate shareholder the earnings and profits of the liquidated corporation merely because gain or loss to the distributee corporation is postponed. The *Sansome* rule affords no basis for the application of the doctrine of inherited earnings to liquidation distributions as distinguished from reorganization exchanges.

The 1936 amendments to section 112(b) (6) removed certain difficulties arising under the 1935 Act which restricted the simplification of corporate structures by liquidation of subsidiaries. (Senate Discussion, Cong. Rec., Vol. 80, p. 8799, Seidman's *Legislative History of Federal Income Tax Laws, 1938-1961*, pp. 242, 244.)

Congress at the same time enacted section 113(a) (15) of the Revenue Act of 1936 which section provided that the basis of the property received by the parent corporation should be the same basis as it would be in the hands of the transferor corporation instead of the substituted basis prescribed in the 1935 Act. Senator George in explaining this change stated

the reasons therefor as follows (Cong. Rec., Vol. 80, p. 8799, Seidman's *Legislative History of Federal Income Tax Laws, 1938-1961*, p. 244) :

“The protection of the Treasury, as well as sound policy, requires that the property retain the same basis after the liquidation as before.”

Apparently it was believed that the transferor's basis for the property distributed to the parent corporation would, in general, impose on the parent corporation a lower basis than that of the stock surrendered, and upon the subsequent disposition of the property in a taxable transaction this would result in greater taxable gain or lesser recognized loss on the transaction than would result from the transferee's substituted basis for the stock. An added reason for the change may have been to overcome to a considerable extent the difficulties which would have arisen under the 1935 Act in allocating the basis of the parent's investment among the various assets of the subsidiary distributed to the parent in liquidation instead of simply taking the transferor's basis as to each asset. (See Art. 113(a)(6)-1 of Regulations 86 as amended to conform to Revenue Act of 1935, T.D. 4626, C.B. XV-1, pp. 61, 74; Montgomery, *Federal Income Tax Handbook, 1936-1937*, p. 242.) In any event it is apparent that the change requiring the parent corporation to use the transferor's basis instead of its own substituted basis was entirely unrelated to the question whether Congress intended that the doctrine of inherited earnings established in the *Sansome* case should apply to liquidations under sec-

tion 112(b) (6) of the Revenue Act of 1936. There is no indication whatsoever that in 1936 Congress intended that upon the liquidation of a subsidiary corporation the earned surplus of the parent should be increased by *both* the earned surplus of the subsidiary and any recognized profit to the parent, computed on the transferor's basis, upon the ultimate disposition of the assets of the subsidiary corporation, thus discriminating against corporations receiving property in a corporate liquidation as compared with shareholders other than corporations.

- (c) The codification of the Sansome rule in section 115(h) of the Revenue Act of 1936 not only indicated the traditional scope of the rule but also indicated that in 1936 Congress did not intend the Sansome rule to be applicable to a complete liquidation of a subsidiary corporation pursuant to section 112(b) (6). The 1938 amendment to section 115(h) was not retroactive.

The most compelling factor indicating that in 1936 Congress did not intend that the Sansome rule be applicable to liquidations under section 112(b) (6) of the Revenue Act of 1936 appears from the fact that when section 112(b) (6) was enacted in 1936 to make complete liquidations of subsidiary corporations non-taxable Congress at the same time enacted section 115(h) which codified the rule of the *Sansome* case and confined its application to exchanges in reorganization, the situation to which the rule had been traditionally applied. Since Congress did not at such time enact a like rule with respect to complete liquidations of subsidiaries under section 112(b) (6) it must be assumed that in 1936 Congress did not intend

that the *Sansome* rule should apply to liquidations of subsidiaries not a part of a reorganization. Section 115(h) provided as follows:

“Section 115(h). *Effect on Earnings and Profits of Distributions of Stock.*—The distribution (whether before January 1, 1936, or on or after such date) to a distributee by or on behalf of a corporation of its stock or securities or stock or securities in another corporation shall not be considered a distribution of earnings or profits of any corporation—

(1) if no gain to such distributee from the receipt of such stock or securities was recognized by law, or

(2) if the distribution was not subject to tax in the hands of such distributee because it did not constitute income to him within the meaning of the Sixteenth Amendment to the Constitution or because exempt to him under Section 115(f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.

As used in this subsection the term ‘stock or securities’ includes rights to acquire stock or securities.”

It should be noted that section 115(h) only seeks to cover the effect on earnings and profits of a distribution to a “distributee” of (1) the distributing corporation’s own stock or securities, or (2) stock or securities of another corporation. The section did not include distributions of assets other than the distributing corporation’s own stock or securities or stock or securities of another corporation.

On the other hand, Regulation 94 which accompanied the Revenue Act of 1936 provided as follows:

*"Art. 115-11. Effect of earnings or profits of certain tax-free exchanges and tax-free distributions.—If, under the law applicable to the year in which any transfer or exchange of property after February 28, 1913, was made (including transfers in connection with a reorganization or a complete liquidation under Section 112(b)(6) and intercompany transfers of property during a period of affiliation), gain or loss was not recognized (or was recognized only to the extent of the property received other than that permitted by such law to be received without the recognition of gain), then proper adjustment and allocation of the earnings or profits of the transferor shall be made as between the transferor and transferee corporations.*

The general rule provided in Section 115(b) that every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits, does not apply to:

(1) The distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, to its shareholders of stock or securities in such corporation or in another corporation a party to the reorganization—

(A) in any taxable year beginning before January 1, 1934, without the surrender by the distributees of stock or securities in such corporation (see Section 112(g) of the Revenue Act of 1932); or

(B) in any taxable year (beginning before January 1, 1936, or on or after such date) in exchange for its stock or securities (see Section 112(b)(3))

if no gain to the distributees from the receipt of such *stock* or *securities* was recognized by law.

(2) A stock dividend which was not subject to tax in the hands of the distributee because either it did not constitute income to him within the meaning of the Sixteenth Amendment to the Constitution or because exempt to him under Section 115(f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act. A distribution described in paragraphs (1) and (2) above does not diminish the earnings or profits of any corporation. In such cases, the earnings or profits remain intact and available for distribution as dividends by the corporation making such distribution, or by another corporation to which the earnings or profits are transferred upon such reorganization or other exchange.

For the purposes of this article, the terms 'reorganization' and 'party to the reorganization' shall, for any taxable year beginning before January 1, 1934 have the meanings assigned to such terms in Section 112 of the Revenue Act of 1932, and for any taxable year beginning after December 31, 1933, and before January 1, 1936, have the meanings assigned to such terms in Section 112 of the Revenue Act of 1934." (Italics added.)

It was not until the Revenue Act of (May 28) 1938, and after the liquidation in 1936 of Cole-French Com-

pany, that Congress sought to give the *Sansome* rule an entirely new application to tax-free liquidations of subsidiary corporations not connected with a reorganization. Section 115(h) as amended by the 1938 Act provided as follows:

“Section 115(h). *Effect on earnings and profits of distributions of stock.*—The distribution (whether before January 1, 1938, or on or after such date) to a distributee by or on behalf of a corporation of its stock or securities, of stock or securities in another corporation, or of property or money, shall not be considered a distribution of earnings or profits of any corporation—

(1) if no gain to such distributee from the receipt of such stock or securities, or of property or money, was recognized by law, or

(2) if the distribution was not subject to tax in the hands of such distributee because it did not constitute income to him within the meaning of the Sixteenth Amendment to the Constitution or because exempt to him under Section 115(f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.

As used in this subsection the term ‘stock or securities’ includes rights to acquire stock or securities.” (Italics added.)

The pertinent portions of Regulations 101 which accompanied the Revenue Act of 1938 are as follows:

“Art. 115-11. *Effect on earnings or profits of certain tax-free exchanges and tax-free distributions.*—If, under the law applicable to the year in which any transfer or exchange of property

after February 28, 1913, was made (including transfers in connection with a reorganization or a complete liquidation under Section 112(b)(6) and intercompany transfers of property during a period of affiliation), gain or loss was not recognized (or was recognized only to the extent of the property received other than that permitted by such law to be received without the recognition of gain), then proper adjustment and allocation of the earnings or profits of the transferor shall be made as between the transferor and transferee corporations.

The general rule provided in Section 115(b) that every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits, does not apply to:

(1) The distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, to its shareholders of stock or securities in such corporation or in another corporation a party to the reorganization—

(A) in any taxable year beginning before January 1, 1934, without the surrender by the distributees of stock or securities in such corporation (see Section 112(g) of the Revenue Act of 1932); or

(B) in any taxable year (beginning before January 1, 1938, or on or after such date) in exchange for its stock or securities (see Section 112(b)(3))

if no gain to the distributees from the receipt of such stock or securities was recognized by law.

(2) *The distribution in any taxable year (beginning before January 1, 1938, or on or after such date) of stock or securities, or other property or money, to a corporation in complete liquidation of another corporation, under the circumstances described in Section 112(b)(6) of the Revenue Act of 1936 or Section 112(b)(6) of the Revenue Act of 1938.*

(3) \* \* \*

(4) A stock dividend which was not subject to tax in the hands of the distributee because either it did not constitute income to him within the meaning of the Sixteenth Amendment to the Constitution or because exempt to him under Section 115(f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.

A distribution described in paragraph (1), (2), (3) or (4) above does not diminish the earnings or profits of any corporation. In such cases, the earnings or profits remain intact and available for distribution as dividends by the corporation making such distribution, or by another corporation to which the earnings or profits are transferred upon such reorganization or other exchange. *In the case, however, of amounts distributed in liquidation (other than a tax-free liquidation or reorganization described in paragraph (1), (2), or (3) above) the earnings or profits of the corporation making the distribution are diminished by the portion of such distribution properly chargeable to earnings or profits accumulated after February 28, 1913, after first deducting from the amount of such distribution the portion thereof allocable to capital account.*

For the purposes of this article, the terms 'reorganization' and 'party to the reorganization' shall, for any taxable year beginning before January 1, 1934, have the meanings assigned to such terms in Section 112 of the Revenue Act of 1932; for any taxable year beginning after December 31, 1933, and before January 1, 1936, have the meanings assigned to such terms in Section 112 of the Revenue Act of 1934; *and for any taxable year beginning after December 31, 1935, and before January 1, 1938, have the meanings assigned to such terms in Section 112 of the Revenue Act of 1936.*" (Italics added.)

The omitted portion deals with distributions described in section 371 made in obedience to orders of the Securities and Exchange Commission; the italics in the above article indicate new matter.

It must again be noted that section 115(h) of the Revenue Act of 1936 involves distributions of *stock or securities* only and was framed to give effect to the *Sansome* rule as traditionally applied to transfers in connection with a reorganization. Section 115(h) of the Revenue Act of 1936 did not expressly or by implication purport to cover distributions of *property* in connection with the complete liquidation of a subsidiary pursuant to section 112(b) (6) of the 1936 Act.

It is significant that the first suggestion or intimation that the *Sansome* rule might be applicable to liquidations under section 112(b) (6) of the Revenue Act of 1936 appears in Article 115-11 of Regulations 94 set forth above (pp. 23-24) and which accompanied

the 1936 Act, in which regulation respondent purported to enlarge upon section 115(h) of the 1936 Act by including within its scope all "property" and not merely stock or securities. On the basis of such enlargement which was clearly unauthorized the regulation sought to do what the Courts had never done and what the statute did not do, namely, to apply the *Sansome* rule to complete liquidations under section 112(b) (6) of the Revenue Act of 1936.

The question whether the *Sansome* rule should be made applicable to a liquidation of a subsidiary under section 112(b) (6) and consummated prior to the 1938 Amendment to section 115(h) must be considered against the background of decisions applying the *Sansome* rule and the statement of the rule in section 115(h) of the Revenue Act of 1936. This question cannot be foreclosed by assuming that the principle of the *Sansome* rule would have been applicable to corporate liquidation had section 115(h) never been enacted. To read section 112(b) (6) of the Revenue Act of 1936 as a gloss upon section 115(a) when Congress in enacting section 112(b) (6) had at the same time in section 115(h) enacted its understanding of the *Sansome* rule appears to be a form of judicial legislation in which the Courts have often announced they cannot and will not indulge. It must be assumed that in failing to provide in section 115(h) of the 1936 Act that the doctrine of inherited earnings should also apply to liquidations of subsidiary corporations under section 112(b) (6), Congress did so because it did not consider the *Sansome* rule applicable to that entirely different

situation. Had Congress intended in 1936 to make the *Sansome* rule applicable to 112(b) (6) liquidations it would have used the appropriate terminology later used in the 1938 Amendment to section 115(h). (*Wallace v. Commissioner* (9 Cir., 1944), 144 Fed. (2d) 407, 410.) Indeed, until the Treasury promulgated Article 115-11 of Regulations 94 there was absolutely no suggestion either by judicial decision or statute that the *Sansome* rule applied to liquidation distributions not a part of a reorganization.

Under the circumstances the enactment of the 1938 Amendment clearly indicates a change in the law as theretofore existing. It would appear therefore that the basic question should be whether a Court may by judicial innovation extend the *Sansome* rule to cover the entirely new and different situation involved in the liquidation in 1936 of a subsidiary under section 112(b) (6) despite the congressional intent as expressed in section 115(h) of the Revenue Act of 1936. Petitioner respectfully submits that in view of the enactment of the *Sansome* rule in section 115(h) the Tax Court erred in treating section 115(h) as entirely irrelevant to a liquidation in 1936 of a subsidiary corporation. Moreover, since Congress sought to state its understanding of the *Sansome* rule in section 115(h) it is respectfully submitted that the Tax Court erred in enlarging section 115(h) to embrace corporate liquidations not a part of a reorganization and in effect applying Article 115-11 of Regulations 94 to a situation outside the scope of section 115(h).

If the *Sansome* rule as enacted by Congress in section 115(h) prior to the 1938 Amendment did not apply to distributions of money or property in connection with a complete liquidation, Article 115-11 of Regulations 94 in so far as it purported to prescribe a rule that a distribution of money or property in a complete liquidation to a distributee corporation increased the earnings or profits of said corporation was without statutory authority.

It is well settled that a regulation which is broader than the statute which it purports to interpret is invalid and "a mere nullity". The rule is stated by the United States Supreme Court in *Manhattan General Equipment Co. v. Commissioner* (1936), 297 U.S. 129, 56 Sup. Ct. 397, 80 L. Ed. 529, at page 129, as follows:

"The power of an administrative officer or board to administer a federal statute and to prescribe rules and regulations to that end is not the power to make law—for no such power can be delegated by Congress—but the power to adopt regulations to carry into effect the will of Congress is expressed by the statute. A regulation which does not do this, but operates to create a rule out of harmony with the statute, is a mere nullity. *Lynch v. Tilden Produce Co.*, 265 U.S. 315, 320-322, 68 L. ed. 1034-1036, 44 S. Ct. 488; *Miller v. United States*, 294 U.S. 435, 439, 440, 79 L. ed. 977, 980, 981, 55 S. Ct. 440, and cases cited. \* \* \*"

See also

*Helvering v. Janney* (1940), 311 U.S. 189, 194, 61 S. Ct. 241, 85 L. Ed. 118.

Respondent contended in the Tax Court that the 1938 Amendment to section 115(h) merely sought to clarify the existing law which respondent contended made the *Sansome* rule applicable in 1936 to complete liquidations of a subsidiary. If the Tax Court assumed that the 1938 Amendment to section 115(h) merely clarified but did not extend the section as previously enacted by Congress, it is clear from the authorities that such rule of statutory construction was unwarranted. The enlargement of section 115(h) of the Revenue Act of 1936 to include distributions of property in complete liquidation under section 112(b) (6) was not a mere clarification but was a complete amendment of the statute to apply to an entirely new and unrelated factual situation to which the *Sansome* rule had never theretofore been applied.

In *Commissioner v. Windrow* (5 Cir., 1937), 89 Fed. (2d) 69, at page 71, the Court stated the rule as to statutory construction as follows:

“Courts and administrative agencies are bound to enforce the plain words of the statute although there may be reason to think, in view of the general legislative purpose that some other provision would have met with favor if the Legislature had called it to mind.”

In *Commissioner v. Kay Mfg. Corp.* (2 Cir., 1941), 122 Fed. (2d) 443, respondent likewise argued that section 115(h) of the Revenue Act of 1936 covered distributions of property as well as stock or securities. In answer to this argument the Circuit Court of Appeals stated at page 445:

"The argument is buttressed by reference to Section 115(h). As this deals only with stock or securities we are unable to see its relevance. It is true that in the Revenue Act of 1938 Section 115(h), 26 U.S.C.A. Int. Rev. Acts, page 1057, was broadened to include money or property, but this is of slight consequence in interpreting the earlier law. See *Wild v. Commissioner*, 2 Cir., 62 F.2d 777, 780. \* \* \* It should not be overlooked that the Revenue Act of 1936 was intended not only to raise revenue but also to encourage the simplification of corporate structures. See the President's message to Congress, H.R. No. 1681, 74th Cong. 1st sess."

Article 115-11 of Regulations 94 cannot serve as a basis for applying the *Sansome* rule to a liquidation in 1936 of Cole-French Company.

In the recent case of *Sabine Transp. Co., Inc. v. Commissioner* (5 Cir., 1942), 128 Fed. (2d) 945, Judge Hutcheson dealt with the power of the Commissioner by regulation to read words into or out of the revenue laws in a manner contrary to the expressed provisions of the statute, as follows (page 947):

"We think it clear that in attempting, by speculating as to what Congress intended to do except as that intent was expressed in the statute, to rationalize out of the section the comprehensive words which specifically grant the deduction, the Commissioner is attempting to have us arrogate to ourselves the function of rewording rather than of construing and applying the statute. The construction of a statute to make it carry out the intent its words import is one thing. The con-

struction of it to bring it nearer to the thought of administrator or court, or of some particular section of public opinion, as to what Congress intended or ought to have intended, or that the law would better serve its purpose if it were drawn that way, is quite another. However, we need not further labor the point here, for in *Helvering v. Credit Alliance Corp.*, April 27, 1942, 62 S. Ct. 989, 992, 86 L. Ed. ...., the Supreme Court rejecting the same kind of reasoning as to a dividends paid credit claimed under Section 27(b) (sic) of the Revenue Act of 1936, and declaring invalid a regulation which contravened the plain terms of the statute, has set the matter at rest. Definitely reaffirming the principle that it is for the courts not to write but to enforce a statute, the court said: '*But we cannot, as the Government suggests, read into the section, as it stood when the transaction took place, an intent derived from the policy disclosed by the subsequent amendment.'*' (Italics added.)

The foregoing construction of section 115(h) of the Revenue Act of 1936 is in accord with the position taken by the Supreme Court in *Helvering v. Credit Alliance Corp.* (1942), 316 U.S. 107, 62 S. Ct. 989, 86 L. Ed. 1307, affirming 122 Fed. (2d) 361. It is true as the Tax Court observes in its opinion in the instant case (R. p. 21) that the *Credit Alliance* case was concerned with the question whether the liquidated subsidiary should be denied a dividend paid credit under section 27(f) of the Revenue Act of 1936 by reason of the fact that the distribution in liquidation under section 112(b) (6) did not constitute a taxable divi-

dend in the hands of the distributee corporation and the Courts in that case were not called upon to consider whether under the *Sansome* rule the earnings and profits of the liquidated subsidiary would be attributable to the distributee corporation. However, the statements of the Courts in the *Credit Alliance* case are certainly of significance with respect to the scope of section 115(h) and the effect of the 1938 Amendment thereto.

In the *Credit Alliance* case the Commissioner argued that *since* under the *Sansome* rule the distributee corporation inherited the earnings of the liquidated subsidiary the liquidated subsidiary should be deemed not to have distributed such earnings under section 27(f). It is to be noted that this argument assumes the precise issue involved in this case. The remarks of the Circuit Court of Appeals which *assumed* that the *Sansome* rule would apply to the distribution of earnings or profits in the hands of the distributee were made in answer to the Commissioner's argument, without giving a complete consideration to the effect of section 115(h) of the Revenue Act of 1936 on subsidiary liquidations. The Court, in effect, stated that *assuming* the *Sansome* rule applicable to the distributee corporation, the liquidated subsidiary was nevertheless entitled to a dividend paid credit under section 27(f). That the Court did not, however, dispose of the question whether the *Sansome* rule was applicable to a complete liquidation in 1936 of a subsidiary corporation under section 112(b) (6), and in fact raised a doubt as to such applicability, appears

from the following statement, at 122 Fed. (2d) 361, 365:

"The Commissioner's argument refers also to Section 115(h) of the Act, 26 U.S.C.A. Int. Rev. Acts, page 870, which provides that a distribution to a distributee by a corporation of its stock or securities, or stock or securities in another corporation, shall not be considered a distribution of corporate earnings or profits if no gain to the distributee from the receipt of such stock or securities was recognized by law. It is said that this section is an express legislative recognition of the principle of *Commissioner v. Sansome*, supra, as indeed it is, and hence a similar restriction, although not expressed, should be implied in Section 27(f) so that only those liquidating distributions which give rise to taxable gains in the hands of the distributee should be treated as taxable dividends paid.

In answer to this argument it is sufficient to say that the government adds no strength to its position by pointing out that Section 115(h) of the Act of 1936 also involves a recognition of the principle of the *Sansome* case already considered above. Whether the same result would be reached under Section 115(h) of the Act of 1938, which adds tax-free distributions of 'property or money' to the category of transactions not to be considered as distributions of earnings or profits, we have no occasion now to consider. The reference to the transfer or exchange of 'property' in Article 115(h) of Treasury Regulations 94, promulgated under the Revenue Act of 1936, was obviously unauthorized if it was intended as an enlargement of the scope of the corresponding section of the Act."

The Supreme Court, in the same case, likewise expressed its disapproval of the Commissioner's contention that the 1938 Amendment to section 115(h) made said section applicable to a 1936 liquidation of a subsidiary, saying, 316 U.S. 107, 112:

"The petitioner points out that the Revenue Act of 1936 introduced a new policy,—to tax undistributed earnings in order to prevent a taxpayer from accumulating untaxed surplus by forcing the payment of dividends which become taxable in the hands of the distributee. This is true, but it is also true that the Act made distributions to parent corporations nontaxable in order to encourage the simplification of corporate structures. It was avowedly for this reason that § 112(b)(6) provided that no gain or loss to the parent company should in such case be recognized, and it may well be that subsection (f) of § 27 was inserted with the same purpose. The Government insists that as § 115(h) provides that a distribution of the taxpayer's stock or securities, or those of another corporation, shall not be considered a distribution of earnings or profits of the taxpayer if no gain to the distributee from the receipt of such stock or securities is recognized by the law, subsection (f) must be read in the light of the policy thus declared by § 115(h). *The latter section is irrelevant to this controversy because the distribution here was in property and money and not in stock or securities. Section 115(h) was amended in 1939 subsequent to the consummation of the transaction here in question to include money or property, but we cannot, as the Government suggests, read into the section, as it stood when the transaction took place, an intent derived from the policy disclosed by the subsequent amendment.*" (Italics added.)

Since the *Sansome* rule was traditionally applicable only to exchanges in reorganization and Congress in enacting section 115(h) of the Revenue Act of 1936 did not enact a like rule with respect to complete liquidations of subsidiary corporations the Tax Court erred in reading into section 115(h) "an intent derived from the policy disclosed by the subsequent (1938) amendment" to that section. (See *Helvering v. Credit Alliance Corp.*, *supra*, 316 U.S. 107, 112.)

It is respectfully submitted that the doctrine of inherited earnings was not applicable to the complete liquidation in 1936 by Cole-French Company pursuant to section 112(b) (6) of the Revenue Act of 1936. Accordingly, it was error to increase the earnings and profits of Metropolitan by the earnings and profits of Cole-French Company at the date of its complete liquidation.

Dated, San Francisco, California,

December 27, 1944.

Respectfully submitted,

JESSE H. STEINHART,

JOHN J. GOLDBERG,

*Counsel for Petitioner.*

No. 10908

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In the United States Circuit Court of Appeals  
for the Ninth Circuit

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LENORE S. ROBINETTE, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

---

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX  
COURT OF THE UNITED STATES

---

BRIEF FOR THE RESPONDENT

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FILED

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# In the United States Circuit Court of Appeals for the Ninth Circuit

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No. 10908

LENORE S. ROBINETTE, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

---

*ON PETITION FOR REVIEW OF THE DECISION OF THE TAX  
COURT OF THE UNITED STATES*

---

## BRIEF FOR THE RESPONDENT

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### OPINION BELOW

The opinion of the Tax Court of the United States (R. 14-21) is not reported.

### JURISDICTION

This case involves the income tax liability of Lenore S. Robinette for the period February 1, 1939, to December 31, 1939. Notice of deficiency was mailed on January 9, 1943 (R. 9), and the petition for re-determination was filed with the Tax Court on April 5, 1943 (R. 1), pursuant to Section 272 (a) of the Internal Revenue Code. The decision of the Tax Court was entered on April 27, 1944. (R. 22.) The motion for rehearing and reconsideration was filed on May 25, 1944 (R. 2, 22-26), and the order denying the mo-

tion entered on June 5, 1944 (R. 32-33). The petition for review was filed on August 30, 1944. (R. 34-41.) Venue was stipulated by agreement pursuant to Section 1141 (b) (2) of the Internal Revenue Code, and the jurisdiction of this Court rests upon Sections 1141-1142 of the Internal Revenue Code.

#### **QUESTION PRESENTED**

A parent corporation within the scope of Section 112 (b) (6) of the Revenue Act of 1936 completely liquidated a wholly owned subsidiary having earnings or profits accumulated after February 28, 1913. In 1939 the parent made a distribution to its shareholders. Was the distribution made from the parent's earnings or profits under Section 115 (a) and (h) of the Internal Revenue Code?

#### **STATUTES AND REGULATIONS INVOLVED**

These will be found in the Appendix, *infra*.

#### **STATEMENT**

The facts relevant for this appeal as found by the Tax Court may be summarized as follows:

During the year 1939 taxpayer owned  $833\frac{1}{3}$  shares of stock of the Metropolitan Properties Company, a corporation organized under the laws of the State of California on November 21, 1924. As a stockholder of that corporation she received in the period involved distributions from the corporation amounting to \$7,916.60. Taxpayer returned as taxable income \$2,047.63 of that amount, or 25.865%. The return was made upon advice from the corporation that of the total distribution to her \$5,868.97 or 74.135%

was a distribution from capital and not from earnings, profits or surplus. (R. 14-15.)

Metropolitan was on December 24, 1936 the sole stockholder of the Cole-French Company. (R. 15.) On that day Cole-French, in complete liquidation, distributed all of its assets subject to liabilities to Metropolitan in exchange for all of its shares, which were then cancelled and the corporation forthwith dissolved. (R. 17.) Immediately prior to the liquidation Cole-French had earnings or profits accumulated after December, 1919, of at least \$225,000. (R. 20, 42.)

The distribution by Cole-French to Metropolitan was in pursuance of the complete liquidation of a wholly owned subsidiary. By virtue of the provisions of Section 112 (b) (6) of the Revenue Act of 1936 no gain or loss to Metropolitan was recognized. (R. 18.) The fair market value of the assets less liabilities received by Metropolitan exceeded the adjusted basis of the stock of Cole-French in the hands of Metropolitan by not less than \$200,000, but during 1939 the fair market value of those assets still retained by Metropolitan declined by more than \$200,000. (R. 18.)

The Tax Court affirmed the determination of the Commissioner that upon the complete liquidation of Cole-French in 1936 the earnings or profits of that company should be included in determining whether the cash distributions by Metropolitan in 1939 were taxable in full as dividends paid out of its earnings or profits accumulated after February 28, 1913, under the doctrine of the *Sansome* case. (R. 19-21.) From this decision, taxpayer appeals.

**SUMMARY OF ARGUMENT**

The legislative history, regulations and express language of Section 115 (h) of the Internal Revenue Code clearly provide that the earnings or profits of a subsidiary corporation completely liquidated by its parent under Section 112 (b) (6) of the Revenue Acts of 1936, 1938 or the Internal Revenue Code retain their character as such in the hands of the parent and are available for the future distribution of taxable dividends. This controversy involves income tax liability for the last 11 months of 1939. The transaction giving rise to tax—the distribution by Metropolitan to taxpayer—took place in 1939 and was covered by the Internal Revenue Code. Hence, taxpayer's emphasis upon the applicability of the Revenue Act of 1936 and the result which allegedly would follow were it controlling is entirely misplaced. The distribution was thus made from Metropolitan's earnings or profits accumulated after February 28, 1913, and inherited at the time Cole-French was liquidated tax-free under Section 112 (b) (6) of the Revenue Act of 1936. Moreover, regardless of the character of the assets at the moment they passed from Cole-French to Metropolitan, Congress could change, assuming *arguendo* it was a change, the federal definition of a taxable dividend by altering its previous description of earnings or profits. At most this involves the retroactive application of rules for determining current taxable income which is entirely within the Congressional power.

But even if the Revenue Act of 1936 were applicable, the instant distribution would still be out of

Metropolitan's earnings or profits under Section 115 (h) of the Revenue Act of 1936 and the rule of the *Sansome* case. There are no essential differences between an isolated corporate liquidation of a subsidiary corporation and one connected with a reorganization, and the series of cases applying the *Sansome* doctrine involve many where the transferor corporation has been liquidated in connection with a reorganization. No gain or loss is recognized in both instances and there is present complete identity of the two corporations and continuity of the proprietary interest. The parent retains the earnings of the subsidiary and the earnings do not simply vanish after the liquidation. The rule in the *Sansome* case would always have been applied in a tax-free liquidation of a wholly owned subsidiary and its application should not be precluded by the enactment of Section 115 (h) of the Revenue Act of 1936 which was intended to give express legislative approval to the doctrine.

#### **ARGUMENT**

**The distribution in 1939 was made from Metropolitan's earnings or profits accumulated after February 28, 1913, under Section 115 (a) and (h) of the Internal Revenue Code**

The question in this case involves the source of the cash distribution made by Metropolitan Properties Corporation to taxpayer in 1939. It is the Government's main contention that Section 115 (h) of the Internal Revenue Code (Appendix, *infra*) specifically supplies the answer that the distribution was made out of the corporation's earnings or profits accumulated after February 28, 1913.

Since the agreed statement of facts implied that the distribution in 1939 was not a dividend unless Metropolitan were allocated the earnings or profits of its subsidiary Cole-French Company in the tax-free liquidation of 1936, it was first necessary to demonstrate to the Tax Court that prior to the liquidation, Cole-French actually did have earnings or profits from which dividends could be paid. Taxpayer on this appeal has not seen fit to attack this finding of the Tax Court in favor of the Government and concedes<sup>1</sup> (Br. 4) that immediately prior to its complete liquidation on December 24, 1936, Cole-French had undistributed accumulated earnings or profits in sufficient amounts to cover the entire distribution of Metropolitan in 1939. Thus the sole ground raised by taxpayer for

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<sup>1</sup> The reason is readily understood. In 1929, when Cole-French admittedly had earnings in excess of \$225,000, the directors authorized a bookkeeping transfer from surplus to capital account to pay up the unpaid balance of the stock of the corporation which had not been fully paid for by the shareholders. This was essentially the equivalent of a stock dividend (*Michaels v. McLaughlin*, 20 F. 2d 959 (N. D. Cal.) ; *Teehan v. United States*, 25 F. 2d 884 (Mass.)), not taxable under the Revenue Act of 1928 (*Eisner v. Macomber*, 252 U. S. 189; *Helvering v. Griffiths*, 318 U. S. 371), and thus not capable of reducing earnings or profits available for future dividend distributions within the meaning of Section 115 (h) of the Internal Revenue Code (*Beretta v. Commissioner*, 141 F. 2d 452 (C. C. A. 5th), certiorari denied, October 9, 1944; *Van Norman Co. v. Welch*, 141 F. 2d 99 (C. C. A. 1st); *Century Electric Co. v. Commissioner*, 144 F. 2d 983 (C. C. A. 8th); *Chapman Price Steel Co. v. Commissioner* (C. C. A. 7th), decided December 15, 1944 (1944 P-H, par. 62,810); *Walker v. Hopkins*, 12 F. 2d 262 (C. C. A. 5th), certiorari denied, 271 U. S. 687). But see *Patty v. Helvering*, 98 F. 2d 717 (C. C. A. 2d); *Bedford v. Commissioner*, 144 F. 2d 272 (C. C. A. 2d), certiorari granted, January 8, 1945, relating to liquidating distributions.

attacking the decision of the Tax Court is that the earnings or profits did not retain their character as such in the hands of Metropolitan even though no gain or loss was recognized on the transaction.

We have only to look at the language of the applicable Revenue Act and regulation promulgated thereunder to see the weakness in taxpayer's position. This controversy involves income tax liability for the last 11 months of 1939. The controlling law is that contained in the Internal Revenue Code and the applicable section which specifically governs the problem in Section 115 (h). The provisions of this section are the same as those contained in the Revenue Act of 1938 and taxpayer concedes (Br. 7, 8, 24-25, 30) that this Act provides that after a tax-free liquidation under Section 112 (b) (6) the earnings or profits of the subsidiary retain their character in the hands of the parent and are available for the distribution of taxable dividends. Thus, whatever the reason<sup>2</sup> for the amendment of 1938 which added the words "or of property or money" to Section 115 (h) of the Revenue Act of 1936, c. 690, 49 Stat. 1698, the legislative history,<sup>3</sup> regulations,<sup>4</sup> and simple words of the statute<sup>5</sup>

<sup>2</sup> The committee reports state it to be in the interest of added clarity. See fn. 3, *infra*.

<sup>3</sup> S. Rep. No. 1567, 75th Cong., 3d Sess., pp. 18-19 (1939-1 Cum. Bull. (Part 2) 779, 792) states:

"SECTION 115 (h). *Effect of Distributions on Earnings and Profits.*

"Under existing law, distributions of any property by a corporation which under the provisions of section 112 (b) or (c) are received by the shareholder without the recognition of gain to

(Footnotes<sup>4</sup> and<sup>5</sup> on p. 8)

show that from the taxable year 1938 on, any distribution by a parent corporation out of earnings or profits of its subsidiary liquidated prior to 1938 under Section 112 (b) (6) is a taxable dividend within the meaning of the federal statute. We have here a distribution in 1939. Hence, taxpayer's emphasis upon the application of the Revenue Act of 1936 and the result which allegedly would follow were it controlling is entirely misplaced. Regardless of the character of the assets at the moment they passed from Cole-French to Metropolitan in 1936 surely Congress can change, assuming *arguendo* it was a change, the federal definition of a taxable dividend by altering its previous description of earnings or profits. This raises no problem similar to that involved in *Helvering v. Credit*

him (irrespective of what basis the property takes in the hands of such shareholder) are not regarded as being in any respect distributions of earnings or profits. Consequently, such earnings or profits remain unimpaired out of which taxable dividends may subsequently be declared either by the corporation making the distribution or by another corporation which, as to property acquired in an exchange described in section 112, takes in whole or in part the transferor's basis, so that the earnings or profits of the transferor corporation become in whole or in part the earnings or profits of such other corporation.

"In view of the fact that sections 112 (b) (6) and (7) permit the distribution of property (including money), in addition to stock or securities, without the recognition of gain to the distributee, appropriate changes are made in section 115 (h) of the House bill in the interest of added clarity."

<sup>4</sup> Article 115-11, Treasury Regulations 101, promulgated under the Revenue Act of 1938, is substantially identical with Regulations 103, Section 19.115-11, Appendix, *infra*.

<sup>5</sup> Section 115 (h) of the Revenue Act of 1938, c. 289, 52 Stat. 447, is substantially identical with Section 115 (h) of the Internal Revenue Code, Appendix, *infra*.

*Alliance Co.*, 316 U. S. 107, where the Supreme Court held that an intent disclosed from the 1938 amendment did not affect the 1936 tax liability. Here the transaction giving rise to the tax—the distribution by Metropolitan to taxpayer—took place in 1939 and was covered by the Internal Revenue Code.

It is true that in a sense an example of retroactive application of rules for determining *current* taxable income may be involved. But this obviously cannot be successfully attacked. A prolific source of income tax controversy and litigation is the question of the basis upon which is to be reckoned the gain or loss from the sale or exchange of property and a major point of attack has been the freedom with which Congress has modified this basis of property in the hands of the same taxpayer. The reorganization sections serve to illustrate.<sup>6</sup> Assume a taxpayer acquires property after March 1, 1913, at a cost of \$100,000. By 1923 the property has increased in value to \$1,000,000. If sold in 1923, the basis to be subtracted from the selling price in order to determine gain or loss will be the cost of the property and the resulting taxable gain, \$900,000. So the taxpayer forms a corporation and transfers the property to it in exchange for all its stock. The basis of the property to the corporation is then the fair market value of the property when acquired, or \$1,000,000, and if it sells the property in 1923 no taxable gain will result.<sup>7</sup> The

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<sup>6</sup> The illustration is taken from Ballard, Retroactive Federal Taxation, 48 Harv. L. Rev. 592, 599 (1935).

<sup>7</sup> Nor would there have been any taxable gain on the exchange itself since under the Revenue Act of 1921, Section 202 (c) (3), no gain or loss was recognized on the transfer of property to a

Revenue Act of 1924 met this situation by providing that in the case of property acquired after December 31, 1920, by a controlled corporation, the basis of the property in the hands of the corporation would be the same as in the hands of the transferor. If the property is sold under this new provision even though it was acquired before the enactment, the basis will thus be \$100,000 and the corporation will be taxable on a gain of \$900,000. This Court has upheld this Congressional power to define current taxable income by changing the basis of property already in the hands of the taxpayer. *Osburn California Corp. v. Welch*, 39 F. 2d 41 (C. C. A. 9th), certiorari denied, 282 U. S. 850. See also *Newman, Saunders & Co. v. United States*, 36 F. 2d 1009 (C. Cls.), certiorari denied, 281 U. S. 760; *Lawler v. Commissioner*, 78 F. 2d 567 (C. C. A. 9th); *Martz v. Commissioner*, 82 F. 2d 110 (C. C. A. 9th). As was said in *Phipps v. Bowers*, 49 F. 2d 996, 998 (C. C. A. 2d), certiorari denied, 284 U. S. 641:

The statute was valid and applicable to an earlier purchase and sale, as it was good prospectively. It but defines income for 1921, and taxes the income for that year. If it changed the rate and tax from what the taxpayer expected it to be in view of the earlier statute, it did no more than is always done when a taxing statute is changed.

Congress provided in the Internal Revenue Code that distributions received in 1939 having their source

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corporation by persons "who \* \* \* immediately after the transfer are in control of such corporation."

in assets of subsidiaries liquidated tax-free at any time are from earnings or profits to the extent they so existed in the subsidiary. That at the time of the liquidation in 1936 Metropolitan might then have been able to make a nondividend distribution to taxpayer shows at most a change in definition entirely within the Congressional power.<sup>8</sup>

The foregoing analysis accepted taxpayer's assertion (Br. 21) that Section 115 (h) of the Revenue Act of 1936 represented a legislative attempt to preclude the applicability of the doctrine of *Sansome v. Commissioner*, 60 F. 2d 931 (C. C. A. 2d), certiorari denied, 287 U. S. 667, to tax-free liquidations under Section 112 (b) (6) (Appendix, *infra*) and that if the Revenue Act of 1936 were the controlling law, the distribution in 1939 by Metropolitan to taxpayer would not be out of Metropolitan's earnings or profits. But this as-

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<sup>8</sup> It should be observed that the decision of this Court in *Wheeler v. Commissioner*, 143 F. 2d 162, certiorari granted October 16, 1944, gives a further basis for taxing the distribution as a dividend. For if Section 501 of the Second Revenue Act of 1940, c. 757, 54 Stat. 974, may not be constitutionally applied to the instant case then, per *Wheeler*, the doctrine of *F. J. Young Corp. v. Commissioner*, 103 F. 2d 137 (C. C. A. 3d), and *W. F. Farish & Co. v. Commissioner*, 104 F. 2d 833 (C. C. A. 5th), applies to the 1936 tax-free liquidation. Metropolitan realized on the exchange \$200,000 of earnings or profits, since the fair market value of the assets less liabilities received exceeded the adjusted basis of the stock of Cole-French in the hands of Metropolitan by not less than this amount. (R. 18.) This realized but unrecognized gain under the *Young* and allied cases may be the source of a dividend distribution. That the assets declined in value without being disposed of obviously does not reduce earnings. See 1 Mertens, Law of Federal Income Taxation, Sec. 9.49, and cases there cited.

sertion of taxpayer is without foundation in law. In substance taxpayer's argument comes down to the proposition that although there were earnings or profits prior to the liquidation, immediately thereafter they were gone. Neither the liquidated nor the parent corporation has them, despite the fact the corporate transfer of the earnings or profits resulting in no recognition of gain or loss to Metropolitan. This is an absurd result and wholly out of keeping with the Congressional approval of the doctrine of the *Sansome* case as shown in the committee reports to the Revenue Acts of 1936,<sup>9</sup> 1938<sup>10</sup> and 1940.<sup>11</sup> See *Georday Enterprises v. Commissioner*, 126 F. 2d 384 (C. C. A. 4th). Yet taxpayer in no way justifies this legerdemain. Some writers (1 Mertens, Law of Federal Income Taxation, Sec. 9.58) and courts (*Campbell v. United States*, 144 F. 2d 177 (C. C. A. 3d)), are of opinion that the general principle of inherited earnings or profits does not always apply whenever there is a non-taxable reorganization and that the test should not merely be the tax-free character of the so-called reorganization, but whether in addition there is substantial identity of the several corporations and continuity of the proprietary interest. Even subscribing to this limitation on the *Sansome* doctrine, it in no way precludes the application of the rule here. For the parent has completely taken over the subsidiary. There is complete identity of the corporations and the same share-

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<sup>9</sup> See fn. 12, *infra.*

<sup>10</sup> See fn. 3, *supra*.

<sup>11</sup> H. Rep. No. 2894, 76th Cong., 3d Sess., pp. 41-42. S. Rep. No. 2114, 76th Cong., 3d Sess., p. 25.

holders of the parent who in effect owned the subsidiary and the parent as separate corporations now own the parent embodied with the subsidiary. In fact, as pointed out by the Tax Court and contrary to taxpayer's interpretation (Br. 34-36), the Circuit Court in *Helvering v. Credit Alliance Corp.*, 122 F. 2d 361 (C. C. A. 4th), had no doubt that the earnings or profits of a subsidiary corporation, liquidated under Section 112 (b) (6) of the Revenue Act of 1936, retained their character as such in the hands of the parent in accordance with the *Sansome* rule. It there said (p. 365):

This principle [*Sansome*], however, does not necessarily lead to the Commissioner's conclusion [that no dividend credit may be had for a tax-free liquidation distribution]. It is obvious that Congress may have used the term "earnings or profits" in Section 27 (f) in its customary sense, so as to provide that a distribution thereof in liquidation, as distinguished from a distribution of capital, should give rise to a dividends paid credit, and at the same time have provided in Section 112 (b) (6) that no gain or loss should be recognized upon the receipt by a corporation of property distributed in complete liquidation of another corporation. Indeed these sections read together adhere to the principle of *Commissioner v. Sansome*, *supra*, for they recognize that the property distributed remains in substantially the same hands and that no actual gain or loss has been realized in the transaction. Furthermore, if this interpretation is given, an obstacle to the

simplification of corporate structures desired by Congress is removed.

We think that the term "earnings or profits" was used in Section 27 (f) to exclude from its purview a distribution of capital. We are of opinion, also, that the treatment of the distribution in this case as a taxable dividend paid will not conflict with the purpose of Congress to impose a surtax upon undistributed corporate profits. It is true that a distribution of the property will relieve the taxpayer, the subsidiary corporation, from the payment of an undistributed profits tax, and the receipt of the property by the parent corporation will not require the imposition of a tax upon it for a gain received; but it is not true that the distributee will be under no liability for an undistributed profits tax upon the profit received if it remains undistributed in its hands. The distributor, having distributed the property, is free from the undistributed profits tax; the distributee having received that which in another capacity it already possessed, is not required to pay a tax upon its formal receipt; but there is nothing in the Act which says that the distributee is not subject to a tax upon undistributed profits if it persists in the retention of property which, in its hands as in the hands of the former holder, retains its character as undivided profits. This interpretation has the undoubted advantage, that it gives to Sections 27 (f) and 27 (h) their normal meaning, and at the same time gives effect to the underlying purposes of the Act to tax undistributed corporate profits and also to facilitate

and encourage the simplification of corporate structures.

\* \* \* \* \*

The application of the *Sansome* doctrine to a tax-free liquidation under Section 112 (b) (6) of the Revenue Act of 1936, was thought to apply regardless of the non-applicability of the 1938 amendment adding "or property or money" to tax-free distributions which were not to be considered as distributions of earnings or profits. It is not at all inconsistent that for purposes of a dividend credit, which is a matter of legislative grace, liquidation distributions of property are treated as taxable dividends paid of amounts properly charged to earnings or profits, yet because no tax is due from the distributee corporation, the earnings or profits remain unchanged in its hands. The *Credit Alliance* case was only concerned with the problem of the credit to be given in determining the 1936 surtax liability, where in 1938 the Congress expressly said that tax-free distributions of property did not diminish earnings or profits. Although the case held that this latter expressed intent could not affect the interpretation of Section 27 (f) of the 1936 Act, it did not hold that the parent did not retain the earnings of the subsidiary and that the earnings simply vanished after the transaction.

And we fail to see the magic as does taxpayer (Br. 15-17) in the isolated liquidation of a corporation. The series of cases applying the *Sansome* doctrine involve many where the transferor corporation has been liquidated in connection with a reorganization.

The reorganization aspect merely makes the transaction tax free. It does not change the bald fact that one company is liquidated and another takes over its assets, earnings and profits. *Baker v. Commissioner*, 80 F. 2d 813 (C. C. A. 2d), is a good example of this. There, X corporation owned all the stock of A, B, C, D, and E corporations. X then formed Y corporation and exchanged A, B, C, D, and E stock for Y stock. At this moment Y is the parent owning all the stock of A, B, C, D, and E—the same as Metropolitan was the sole shareholder of Cole-French. Y then took over all the assets and assumed all the liabilities of A, B, C, D, and E in exchange for their stock. This was in effect the liquidation of subsidiaries into the parent. When Y made a distribution to X (comparable to Metropolitan's distribution to taxpayer) the distribution was from its earnings or profits derived from A, B, C, D, and E. Thus the fact the subsidiary is liquidated rather than merged or consolidated has nothing to do with the rationale of *Sansome*. In the last analysis the same individual shareholders receive the distribution whether the transaction takes the form of an isolated liquidation or one connected with a reorganization.

Taxpayer's argument for a distinction seems to be based upon a misconception of the mechanics of the reorganization and basis sections of the Revenue Acts. It is argued (Br. 15-16) that in the case of the transfer of assets in a reorganization the predecessor or transferor corporation realizes a gain or loss which is unrecognized, whereas in a liquidation the liquidated corporation does not. Not only does this

seem irrelevant, but we submit it is not correct. It is not because the transferor corporation realizes a gain or loss in the transaction that the *Sansome* rule applies. This can be shown by the following illustration:

If A corporation has original assets with a basis of \$100,000 and accumulated earnings or profits of \$100,000 invested in other assets, an exchange for \$200,000 or stock of a newly formed corporation even if recognized, results in no gain to A. A realized gain when it made its profits. And if the exchange is in connection with a tax-free reorganization, the distributee corporation still takes, under *Sansome*, the property of A with its \$100,000 of earnings or profits despite the fact A corporation realized no gain on the exchange. Taxpayer apparently is confusing the situation where there is an appreciation in value of assets which has been held to result in earnings or profits to the transferor even though the assets were disposed of in a tax-free exchange. See *F. J. Young Corp. v. Commissioner, supra*. This being so, taxpayer is also in error (Br. 17-21) in assuming that Section 113 (a) (15) which gives the transferee the transferor's basis in a Section 112 (b) (6) liquidation results in double earnings or profits if the rule in the *Sansome* case also applies. Assume A corporation has original assets with a basis of \$100,000 and earnings or profits of \$100,000 invested in other assets. The basis of all its property is \$200,000. If A is then liquidated by its parent corporation, B, under Section 112 (b) (6), Section 113 (a) (15) also applies and B gets A's basis of \$200,000.

On a subsequent sale of all the property for \$200,000 B realizes no gain. But the earnings or profits of \$100,000 retain their character in B's hands under *Sansome*. There is thus no discrimination (Pet. Br. 21) against corporations receiving property in complete liquidation of subsidiaries. In truth, were taxpayer's contention sound such corporations would be given preferred treatment since the mere fact of liquidation would transmute the earnings to capital and remove them forever from being the source of future dividend distributions. Nor can the liquidation be distinguished on the ground (Pet. Br. 19) that the shareholders are never taxable upon earnings or profits of the liquidated corporation upon their distribution in liquidation. Whether they are or are not does not seem to us important, but it should be noted that Sansome himself was taxed on dividends allocated to earnings or profits in the liquidation distribution under Section 201 of the 1921 Act.

Since there are no essential differences between an isolated corporate liquidation of a subsidiary corporation and one connected with a reorganization, Congress could never have intended, as taxpayer suggests (Br. 29), to have limited the application of the *Sansome* rule in enacting Section 115 (h) of the Revenue Act of 1936. The Senate committee report<sup>12</sup> shows

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<sup>12</sup> S. Rep. No. 2156, 74th Cong., 2d Sess., p. 19 (1939-1 Cum. Bull. (Part 2) 678, 690) states:

"SEC. 115 (h). *Effect of distributions on earnings and profits.*

"The rule, under existing law, with respect to the effect on corporate earnings or profits of a distribution which, under the applicable tax law, is a nontaxable stock dividend or a distribution of stock or securities in connection with a reorganization or other

that Congress believed that Section 115 (h) of the Revenue Act of 1934 and corresponding provisions of prior acts stated the doctrine only in part, and in the interest of greater clarity wished to express in the statute the rules applied by the Treasury and supported by the courts. The *Sansome* rule since its pronouncement in 1932 had been applied to supplement statutory provisions not as broad as Section 115 (h) of the Revenue Act of 1936. Since it always would have been applied to the type of situation involved in the instant case it surely should not be restricted because of the enactment of statutory provisions intended to give express legislative approval to the doctrine.

However interesting these ramifications of the problem are, they are not apposite to the decision in the case. Section 115 (h) of the Internal Revenue Code applies and expressly covers the situation. The distribution in 1939 by Metropolitan to taxpayer was from its earnings or profits which were inherited at

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exchange, on which gain is not recognized in full, is that such earnings or profits are not diminished by such distribution. In such cases, earnings or profits remain intact and hence available for distribution as dividends by the corporation making such distribution, or by another corporation to which the earnings or profits are transferred upon such reorganization or other exchange. This rule is stated only in part in Section 115 (h) of the Revenue Act of 1934, and corresponding provisions of prior Acts, but is the rule which is applied by the Treasury and supported by the courts in *Commissioner v. Sansome* (60 Fed. (2d) 931; *United States v. Kauffman* (62 Fed. (2d) 1045); *Murcheson v. Comm.* (76 Fed. (2d) 641). While making no change in the rule as applied under existing law, the recommended amendment is desirable in the interest of greater clarity."

the liquidation of Cole-French under Section 112 (b) (6) of the Revenue Act of 1936.

**CONCLUSION**

The decision of the Tax Court is correct and should be affirmed.

Respectfully submitted.

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JANUARY 1945.

*Argued by Mrs. Paul*

## APPENDIX

Revenue Act of 1936, c. 590, 49 Stat. 1648:

- SEC. 112. RECOGNITION OF GAIN OR LOSS.

\* \* \* \*

(b) *Exchanges Solely in Kind.*—

\* \* \* \*

(6) *Property Received by Corporation on Complete Liquidation of Another.*—No gain or loss shall be recognized upon the receipt by a corporation of property distributed in complete liquidation of another corporation. \* \* \*

- SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

\* \* \* \*

(15) *Property Received by a Corporation on Complete Liquidation of Another.*—If the property was received by a corporation upon a distribution in complete liquidation of another corporation within the meaning of section 112 (b) (6), then the basis shall be the same as it would be in the hands of the transferor.

Internal Revenue Code:

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this chapter (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earn-

ings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

\* \* \* \*

(h) *Effect on Earnings and Profits of Distribution of stock.*—The distribution (whether before January 1, 1939, or on or after such date) to a distributee by or on behalf of a corporation of its stock or securities, of stock or securities in another corporation, or of property or money, shall not be considered a distribution of earnings or profits of any corporation.—

(1) if no gain to such distributee from the receipt of such stock or securities, property or money, was recognized by law, or

(2) if the distribution was not subject to tax in the hands of such distributee because it did not constitute income to him within the meaning of the Sixteenth Amendment to the Constitution or because exempt to him under Section 115 (f) of the Revenue Act of 1934, 48 Stat. 712, or a corresponding provision of a prior Revenue Act.

As used in this subsection the term "stock or securities" includes right to acquire stock or securities.

\* \* \* \*

(26 U. S. C. 1940 ed., Sec. 115.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:

SEC. 19.115-11. *Effect on earnings or profits of certain tax-free exchanges and tax-free distributions.*—If, under the law applicable to the year in which any transfer or exchange of property after February 28, 1913, was made

(including transfers in connection with a reorganization or a complete liquidation under section 112 (b) (6) and intercompany transfers of property during a period of affiliation), gain or loss was not recognized (or was recognized only to the extent of the property received other than that permitted by such law to be received without the recognition of gain), then proper adjustment and allocation of the earnings or profits of the transferor shall be made as between the transferor and transferee corporations.

The general rule provided in section 115 (b) that every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits, does not apply to:

(1) The distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, to its shareholders of stock or securities in such corporation or in another corporation a party to the reorganization—

(A) in any taxable year beginning before January 1, 1934, without the surrender by the distributees of stock or securities in such corporation (see section 112 (g) of the Revenue Act of 1932); or

(B) in any taxable year (beginning before January 1, 1939, or on or after such date) in exchange for its stock or securities (see section 112 (b) (3))

if no gain to the distributees from the receipt of such stock or securities was recognized by law.

(2) The distribution in any taxable year (beginning before January 1, 1939, or on or after such date) of stock or securities, or other property or money, to a corporation in complete liquidation of another corporation, under the circumstances described in section 112 (b) (6)

of the Revenue Act of 1936, or of the Revenue Act of 1938, or of the Internal Revenue Code.

(3) The distribution in any taxable year (beginning after December 31, 1938) of stock or securities, or other property or money, in the case of an exchange or distribution described in section 371 (relating to exchanges and distributions in obedience to orders of the Securities and Exchange Commission), if no gain to the distributees from the receipt of such stock, securities, or other property or money was recognized by law.

(4) A stock dividend which was not subject to tax in the hands of the distributee because either it did not constitute income to him within the meaning of the sixteenth amendment to the Constitution or because exempt to him under section 115 (f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act. A distribution described in paragraph (1), (2), (3), or (4) above does not diminish the earnings or profits of any corporation. In such cases, the earnings or profits remain intact and available for distribution as dividends by the corporation making such distribution, or by another corporation to which the earnings or profits are transferred upon such reorganization or other exchange. In the case, however, of amounts distributed in liquidation (other than a tax-free liquidation or reorganization described in paragraph (1), (2), or (3) above the earnings or profits of the corporation making the distribution are diminished by the portion of such distribution properly chargeable to earnings or profits accumulated after February 28, 1913, after first deducting from the amount of such distribution the portion thereof allocable to capital account.

For the purposes of this section, the terms "reorganization" and "party to the reorganization" shall, for any taxable year beginning

before January 1, 1934, have the meanings assigned to such terms in section 112 of the Revenue Act of 1932; for any taxable year beginning after December 31, 1933, and before January 1, 1936, have the meanings assigned to such terms in section 112 of the Revenue Act of 1934; for any taxable year beginning after December 31, 1935, and before January 1, 1938, have the meanings assigned to such terms in section 112 of the Revenue Act of 1936; and for any taxable year beginning after December 31, 1937, and before January 1, 1939, have the meanings assigned to such terms in section 112 of the Revenue Act of 1938.

